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WORLD FINANCE SINCE 1914

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By

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PREFACE

THE year 1935 is an important landmark in financial history. It is during that year that the process of world-wide deflation has come to an end and has given way to the irresistible pressure of reflation. Having arrived at this landmark it is perhaps not untimely to look back upon the developments in world finance during the past two decades.

During the last six years or so, the author has published a number of books covering various periods or various aspects of financial development, mostly since 1929. The present volume has a more ambitious aim. It covers the whole period of nearly twenty-one years that began with the outbreak of the war, when the world departed from what were regarded as normal financial conditions. The earlier parts of this interesting period are now sufficiently removed in time to enable us to review it from the perspective of history. Even regarding the more recent developments that preceded the world crisis it is now possible to view them more dispassionately than at the time when they were taking place.

The author must confess that since the publication of some of his earlier volumes he has changed his opinion on various questions of major importance. After the lapse of several years events and actions appear in a totally different light from that in which they were viewed a few months after they took place. In particular, their relative importance in the whole trend of developments can now be gauged more accurately. To give only one example, in 1931 the author regarded the French political attitude in the sphere of international finance as the major cause of the world crisis. To-day he realises that it was merely the executing hand—or, to be correct, one of the innumerable executing hands—through which fundamental influences produced their inevitable effects. While the author is as convinced as ever that French political finance had a substantial share in the responsibility for the crisis, he is equally convinced that given the circumstances in which the currencies were stabilised between 1925 and 1929, a crisis of first-rate gravity was a mere question of time, and that it would have taken place even if the French Governments

had not been guilty of pursuing the destructive policy for which the author considered it necessary at the time to criticise them.

The author has also changed his attitude towards the whole question of monetary policy. While he was never an adherent of the strictly orthodox school, under the influences of the lessons of the last five years he has moved distinctly further from the classical doctrines of the Nineteenth Century. While he has no use for those who believe that monetary conjurers' tricks can solve all the world's evils, he is entirely out of sympathy with those who think that everything ought to be sacrificed for the sake of maintaining the monetary *status quo*. Under the influence of reflationary experience of recent years, he is now decidedly more in favour of a moderate and well-planned policy of monetary expansion than he was in the past.

The author feels he need not blush for having modified his views. It is true that in confessing to having altered his opinions, he exposes himself to the sneers of those who think that once we have committed ourselves in print to one school of thought, it is our sacred duty to adhere to it in no matter what circumstances. This is what they like to call consistency. In the author's view, however, consistency is not incompatible with modifying one's attitude under the influence of changed circumstances. On the contrary, those who refuse to be influenced by facts are themselves guilty of inconsistency, and of a stubbornness which in many cases can only be attributed to moral cowardice or intellectual dishonesty. Those who have an open mind should not hesitate to revise their opinions if necessary in the light of new facts, and should not hesitate to admit having done so.

In criticising the monetary policies pursued during the past twenty-one years, the author undoubtedly pursues the practice of jobbing backward. But then what is history if not jobbing backward? If a historian criticises some past action, he does not necessarily claim that he would have been able to avoid the mistake committed. But it is his task to point out that in the light of subsequent results the action in question proved to be mistaken. In fact, the only way in which past experience can be turned to our advantage is by subjecting it to critical examination. To criticise, however, does not necessarily mean to condemn. While it is necessary to denounce the mistakes made, it is only fair to point out the circumstances which explained the origin of the mistakes. To give an example, the author holds the view that the initial

mistake to which most of our troubles during the last fifteen years have been due was committed by the post-war statesmen in 1920, when they resorted to the high bank rates and credit restriction in order to check the commercial boom, notwithstanding the fact that the rise in commodity prices was the natural process of readjustment brought about by the increase in fictitious wealth during the war. In the author's view, the right course would have been to allow the rise in commodity prices to take its course, and then devalue the currencies on the basis of the level achieved at the peak of the boom. Had this been done, the misery inflicted upon the world by deflation might have been avoided, and the inflationary crisis that followed the slump in many countries might also have been reduced. In the light of subsequent developments, this appears to the author as the right course which ought to have been followed. This does not, however, necessarily mean that had he been in a responsible position in 1920 he would have acted in that sense. The world learns through trial and error, and it would be unfair to condemn statesmen, bankers and economists for not having possessed in 1920 a knowledge of 1935.

It is only those who in 1935 still fail to possess a knowledge of 1935 who deserve criticism. There are still many people who refuse to take into account the fundamental changes that have taken place since 1914 and who would like to judge post-war events through pre-war eyes. Whatever outspoken criticism this volume contains is directed not against those who were in the past incapable of foresight, but against those who refuse to benefit by past experience.

The author has gone out of his way to stress especially two points which he considers important. The one is the spectacular increase of fictitious wealth, which factor is usually underrated. He believes that since its increase was not accompanied by a corresponding increase in real wealth since 1914, a state of fundamental disequilibrium exists, which can only be corrected, either by a reduction of paper wealth, or by an increase of the creation of real wealth. So long as this state of disequilibrium exists, real stability cannot be established. The other point he wants to stress is that no monetary policy can in the long run produce satisfactory results unless it is planned and executed as part of a general system of economic planning. Since 1914, inflation, stabilisation, deflation and reflation have taken place in a haphazard way, which fact goes a long way towards explaining their unsatisfactory results.

The author is convinced, on the basis of the experience of the last two decades, that monetary policy in itself is incapable of solving the problems of progress and prosperity. These problems can only be solved by sacrificing a large part of our economic freedom for the sake of progress coupled with stability that can only be obtained through economic planning.

A detailed explanation of what the author means by economic planning is outside the scope of this book. To put it in a nutshell, while the author believes in private property, he considers it imperative for the sake of the general welfare and progress of mankind that its use should be controlled and regulated in accordance with public interest. While the author considers individual initiative indispensable for progress, in his opinion it should be co-ordinated and regulated in accordance with a general plan. While the author holds the view that State ownership should be the exception and not the rule, in his opinion the State should not hesitate to intervene whenever it is necessary to supplement or correct the activities of private enterprise.

Unless and until economic planning is adopted to an adequate degree, no monetary policy, however skilfully operated, can produce satisfactory results. The author is convinced that the world-wide adoption of planning is a mere question of time. Meanwhile in his opinion the best course to pursue by monetary policy is a drastic devaluation of all currencies, and a return to the gold standard on the understanding that the new parities will be subject to suspension or alteration in case of persistent pressure caused by fundamental disequilibrium. The conception that it is the duty of a nation to defend its gold parities to the last drop of its blood has been the cause of immense sufferings during recent years. It should be discarded and replaced by a more rational conception in which parities should be maintained as a matter of expediency so long as the sacrifices involved in their maintenance remain in proportion to the benefits of stability. It ought to be borne in mind that monetary stability is a means to an end and not the end itself.

P. E.

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CHAPTER I

INTRODUCTORY

(1) Preliminary Remarks

The past two decades constitute undoubtedly the most interesting period in modern financial history. It is not merely because our troubles interest us more than those of earlier generations. The author is convinced that when the future student of history looks back upon this era, he will find it to be of outstanding interest, unless, of course, developments in coming decades overshadow the period of 1914–35. It is sometimes said that the fluctuations and crises experienced since 1914, do not differ fundamentally from similar experiences during the Nineteenth Century, and that the only difference is the increase in the magnitude of the figures involved. Even if this were so, it would be justifiable to regard our period as more interesting from a financial point of view than any previous experiences. After all, figures running into milliards have a fascination of their own. Although our ancestors were just as much concerned with their deficits of a few millions, or with their bank failures involving a million or two as we are with deficits of a many times larger figure and with bank troubles involving milliards, it is impossible not to be awe-struck by the presence of almost astronomic figures.

Nor can the view be accepted that the whole difference between present-day financial developments and those of past periods is a mere question of figures. Our financial system is incomparably more involved than that of previous generations. There is infinitely wider scope for complications than there was at an earlier stage of financial evolution. The comparatively primitive problems which exercised the brains of our predecessors still exist, but in addition, there are highly complicated problems never dreamed of in the Nineteenth Century.

The financial system to-day is much more interwoven than it was before the war. Innumerable new factors and influences have come into existence, and there is an infinitely involved network between them. International financial relations have become highly developed. Links between the sphere of finance and the economic and political spheres have become multiplied. The number of possible situations, potential sources of trouble, alternative remedies, is incomparably larger than it was during past periods, which in comparison with our own we have come to regard as primitive.

We are entitled to claim that our period is much more interesting from a financial point of view than earlier periods. It is not as if we had any reason to be proud of this change. Still less reason have we to be pleased with it. The saying that happy nations have no history holds good in the sphere of finance as well as in the sphere of politics. This generation would undoubtedly have been much happier if its financial history had been dull and monotonous and if authors of books on finance had been at a loss to find subjects to write about, instead of having been at a loss to decide which of the many interesting subjects they should deal with during the limited amount of time at their disposal.

(2) Progress of Economic Science

Another reason why the financial evolution since 1914 is so much more interesting than that of earlier periods is that both economists and the public of our day know very much more about the subject than their predecessors did. This is doubtless a highly controversial statement, and surviving adherents of the classical school would never admit it. They maintain that all there was to be said about economics was said by Adam Smith, Ricardo, and the economists of the Nineteenth Century, and that the task of the economist of the Twentieth Century is confined to the interpretation of the words of wisdom of the classics and their application to our conditions. It is easy to understand that this conception was almost unchallenged during the relatively stable conditions prevailing before the war. Pre-war economists cannot be blamed for believing that their science had said the last word on most of its subjects, and that while there might be some developments regarding the interpretation and application of the principles inherited from their predecessors, the fundamental validity of those time-honoured doctrines remained beyond question. Nobody blames them for their self-satisfaction in believing that what

they did not know about money, foreign exchanges, public finance, banking, etc., was not worth knowing. What is astonishing is that even to-day there are economists who uphold this pre-war conception. And yet, during the past twenty years events amply proved that economists had a great deal to learn. And some of them, at any rate, have learnt a great deal, even though others have learnt nothing and have forgotten nothing.

The irreverent attitude taken up by the progressive school towards the dogmas of the Nineteenth Century has certainly shaken up economic science from its pre-war state of stagnation. What is perhaps even more important from a practical point of view, economic science has become more penetrating than it was before the war. The classical school confined itself as far as possible to vague generalities; indeed, the more vague were the principles they established the better chance they stood that these principles would be applicable to the largest number of cases and for the longest possible period of evolution. Indeed, some of these principles were so infinitely vague as to lose their practical meaning. Since the war, however, economists—or at any rate some of them—have found it inevitable to descend from the clouds, and examine facts such as they are, instead of regarding them as they ought to be on the basis of the classical rules. This tendency manifested itself in the sphere of finance to a particularly high degree. To give only one example, Goschen's *Theory of Foreign Exchanges* was considered until the war as the standard work on the subject. If we compare it with our knowledge of foreign exchanges to-day, we cannot help regarding it as touchingly primitive. This does not mean that we do not recognise the debt of gratitude we owe him for his pioneer work. To do so would be to fall into the other extreme, as a not altogether unnatural reaction from the ancestor-worship of the classical school. But gratitude towards the classics of the science of finance must not prevent us from completing and if necessary correcting and rejecting the legacy they left to posterity.

(3) The Orthodox Attitude

The adherents to the orthodox school have made it their supreme task to interpret the events and developments of our period in the light of the teachings of the classical masters. A great deal of valuable knowledge and energy is wasted upon efforts to adjust the facts so as to make them fit into the ready-made theories established amidst totally different conditions

prevailing in the past century. If the events do not fit, *tant pis pour les faits*. Our duty is to disregard, distort, disallow, discredit, disavow, disdain, disparage and disqualify such inconvenient facts. This, at any rate, is the attitude taken up by a large number of economists, many of whom would be highly qualified to get the maximum of benefit out of the lessons taught by the past two decades if only they regarded the facts without prejudice. It is a great pity that they prefer defending the doctrine to seeking the truth. For, Heaven knows, the fee mankind paid and is still paying for the lessons is high enough; it will be wasted unless their meaning is well understood.

Recent evolution of economic science, in particular its financial section, may best be compared with the evolution of the science of psychology. Until a few decades ago, the science of psychology, like that of economics, confined itself to vague generalities and found itself in a groove with no hope of substantial progress. During the last twenty to thirty years, however, it has gradually penetrated into hitherto unsuspected details and made revolutionary progress in entirely new directions. The modern psychologist has every right to regard the psychologists of past generations as primitive, just as the economist and the financial expert of to-day, provided that he is up to date, has every right to take the same view of his pre-war predecessors. In economics as in psychology, there is a school which deplores the new developments, because recent achievements tend to reduce, to a great extent, the authority of classical doctrines. The attitude of this die-hard school is, however, unable to check the progress which is taking place without them, and to a large extent in spite of them.

(4) "Currency Cranks"

At the other extreme, there are the various shades of currency cranks who are doing their utmost to fish in troubled waters. The experience of recent years has thrown into the melting-pot much of what was considered before the war as being above question. This is, therefore, a unique opportunity for the adventurers of financial literature to obtain a hearing. Such is the discontent with the existing system, that every charlatan preaching against it is bound to recruit followers. All they have to do is to promise the millennium as a result of the application of their special monetary conjurers' tricks, and a section of the public, exasperated by the unwillingness of the orthodox school to keep pace with evolution, becomes the easy victim of their alluring theories. Indeed, the activities

of the various schools of currency conjurers—Douglasites, Soddyites, Technocrats, etc.—have increased enormously during the last few years. It is owing to them that a large section of the public is still inclined to cling to orthodoxy, since the one-sidedness and reckless exaggerations of would-be reformers are apt to cast suspicion in their eyes upon even the most reasonable departures from the rigid dogmatism of the classical school. The legion of currency cranks is, therefore, the most valuable ally of the sworn enemies of progress. On the other hand, the reaction from extreme orthodoxy sends many converts to the camps of currency cranks, so that the relation between the two extremes is reciprocal.

It is of vital importance for the progress and prosperity of mankind that the lessons taught by the past twenty years should be understood correctly. For, as a result of the increased magnitude of the amounts and of the increased complexity of the problems, the penalty paid for mistakes tends to increase. The relative importance of finance not only in the sphere of economics, but in the whole vast sphere of human activity, has increased beyond recognition. The Nineteenth Century had to struggle with problems of production imposed upon mankind by the relatively primitive state of technical progress. To-day this obstacle has been reduced to comparative insignificance. Production could now be increased almost indefinitely. It is now the problem of distribution which provides the chief stumbling block to progress, and distribution is largely, if not exclusively, a financial problem. Unless the problem of distribution is solved, mankind will be unable to benefit by technical progress. Indeed, the benefits of increasing production will be fated to inflict upon mankind crises of increasing magnitude. A great deal is at stake, and everything depends upon the ability of the nations and their leaders to grasp the meaning of the lessons taught by recent experience.

(5) How to Approach the Subject

The material provided by the experience of two eventful decades is admittedly vast, and the task of dealing with it is immense. The number of books written on the subject could fill libraries, and no human being is physically capable of following more than a small percentage of this immense literature. Even if we were to rule out from the scope of the study the endless variety of views expressed on financial developments since 1914 and confined ourselves to analysing the bare facts themselves, the task would appear almost beyond

human capacity. If our task were confined to providing a reference book of the financial events since 1914, the solution would be comparatively easy. All that would be required is a good memory and the intelligent perusal of files of the financial Press and of a few select reference books, covering various sections of the subject. The only dilemma with which the compiler of such a reference book would be confronted, would be the question of procedure: whether to arrange the material in strict chronological order, without regard to the particular developments in each country, or within each section of the subject, whether he should give an historical account of each country, or whether he should take subjects such as public finance, currency, banking, etc., separately. In either case the task performed would be an extremely useful one, but it is doubtful whether it would go a long way towards serving the purpose we have in mind. In order to be able to grasp the deeper-lying trends of evolution, it is necessary to group the facts in the way that brings out these trends most distinctly. A reference book containing facts either in strictly chronological order or assorted according to country or subject, would merely provide the raw material. We propose to go a step further, and use the material for the description and analysis of the four great trends that were evident in the financial history of the last twenty years. These trends are inflation, stabilisation, deflation and reflation, i.e., a deliberately engineered movement to reverse deflation. Doubtless the first three trends existed during past periods, but at no time were they so distinct and universal as during the last twenty years. There has never been such an excellent opportunity to study them under modern conditions.

(6) Inflation, Stabilisation, Deflation and Reflation

The division of this book into four sections dealing with inflation, stabilisation, deflation and reflation is not incompatible with the task of maintaining a certain degree of chronological order, without which it could not be regarded as an historical study. The history of the period begins with inflation all over the world as the inevitable consequence of the conditions created by the war. Between 1914 and 1920 all civilised countries were inflating. In some cases, inflation continued for several years after 1920, but by 1926, it was over in practically every country. The second period in chronological order was that of stabilisation. It is true that to a high degree it has overlapped both the period of

inflation and of deflation, for while attempts at stabilisation began a few years after the war, a number of countries continued to inflate for some time, and in many cases, stabilisation was achieved and maintained by means of deflation. At the same time, it is beyond doubt that the chief characteristic of the period between 1925 and 1931 was the world-wide movement to achieve international monetary stability. The third period, that of deflation, began in the case of some countries soon after the war, while others were still inflating. The period in which deflation becomes the chief characteristic begins in 1929 and is not even yet complete. The fourth period, that of reflation, which should be treated distinctly from the others, began with the suspension of the gold standard in Great Britain, or possibly with the financial crisis in Central Europe in 1931; it has not yet developed sufficiently to assume a world-wide character, but, since it is the logical outcome of excessive deflation, its development into a universal movement is only a question of time.

Evidently it is impossible to fix the exact period for each of the four trends. Economic tendencies are not like the reign of a ruler, the beginning and the end of which can be ascertained to the minute. The exact date when one trend began to make itself felt, when it became the predominating characteristic of the period, and when it disappeared to give way to another trend is impossible to ascertain even if we take the nations separately, and it is still more difficult if we take the world as a whole. But what is really essential is not to define the exact period of the movements, but to analyse their causes, their nature and their effects. From that point of view, it is immaterial if the three periods into which we propose to divide our material, overlap to some degree.

(7) Haphazard Movements

In judging the effects of the four trends, it is essential to allow for the particular circumstances in which they operated. Inflation, stabilisation, deflation and reflation all showed themselves at their very worst in most countries. Inflation during and after the war was the worst kind of unproductive and uncontrolled movement. If a supernatural power wanted deliberately to discredit the idea of inflation, it could not possibly have arranged the circumstances in which it took place more appropriately to suit his purpose. The inflationary experience of 1914–26 will provide the armoury of anti-inflationists with ample weapons and ammunition for genera-

tions to come. The same may be said to hold good for stabilisation. It was badly planned in most countries, even from the national point of view, and it was hopelessly badly planned all over the world from an international point of view. It was a characteristic example of stabilisation attempted in impossible circumstances, and it is only natural that the result should strengthen the case of the anti-stabilisationist forces. Deflation also manifested itself in its most destructive form. The circumstances in which it took place magnified to the extreme the evil effects inherent in the process. As for reflation, the odds were heavily against it. Confronted with almost insurmountable obstacles, its progress up to the time of writing has been dishearteningly slow. The result has not been so far in proportion to the efforts involved.

The four great monetary movements occurred in a haphazard way, amid circumstances that showed them at their worst. Our task will be to attempt to ascertain the degree to which these various adverse circumstances inevitably accompany inflation, stabilisation, deflation and reflation; to ascertain whether any of the processes can be made to take place in circumstances tending to minimise adverse effect and to increase their beneficial influence.

Bearing this in mind, we propose to examine the causes, circumstances and effects of inflation, stabilisation, deflation and reflation during the past twenty years. We shall see how they each affected production, distribution, the budget, markets, banking and trade in general. We shall go beyond the strict limits of economic effects and try to ascertain the political and social effects of the various trends.

(8) Problem of Excessive Fictitious Wealth

To a large extent, the history of post-war finance constitutes a study of the ways in which various countries tried to pay for the war. After twenty years of experimenting, this problem still remains unsolved, and we propose to make it one of the central points of our enquiry. At the time of writing, the commodity value of the huge fictitious wealth created during and after the war is still at a record level, and in practically every country it tends to increase rather than decline.

The deadweight debt created in financing the war and its aftermath is a factor the importance of which is not realised to a sufficient extent by most experts. One of the few exceptions was Lord Bradbury, whose " Memorandum of Dissent ", added

to the Macmillan Report, is the best description of the problem of excessive fictitious wealth. He maintains that one of the main causes of the economic troubles of Great Britain since the war has been the burden of unproductive debt. His remarks on the subject are well worth quoting in full:

> The burden of unproductive debt is partly that of the dead-weight debt arising out of the War. But this is by no means the whole story. The debenture debts of, and bank loans to, industries which cannot, or can only just, make ends meet, and the maintenance of railway rates at the level necessary to provide a return on capital which has to a large extent ceased to be economically productive—to take only two instances—are burdens of a very similar nature.
>
> Out of the total produce of industry the creditor and the State—on behalf of the rentier and also to meet public expenditure on services other than the debt on a vastly enhanced scale —take a much larger proportion than before the War; transport and distribution also take a larger proportion (teste the wider gap between wholesale and retail prices). The remainder after providing for the remuneration of labour is in many industries not enough to leave a sufficient margin to induce the entrepreneur to continue his exertions or hazard fresh capital. The weakest close down and the maintenance of the workmen thrown out of employment increases the pressure on those still at work. The next weakest then succumb and the process seems likely to continue until the volume of production is so reduced as to be unable to support over the whole country even the standard of life at present enjoyed by the unemployed.
>
> It is no doubt true that the payment of the interest on internal debt and allowances to unemployed workmen are merely "a transfer of incomes within the country," but (except in so far as they are met by the taxation of rentier or the unemployed workman himself) it is a transfer from the producer to the non-producer. If it goes far enough it will leave the producer with no motive to produce and in the end cease perforce because there will be nothing to transfer.
>
> That catastrophe has not occurred earlier is mainly the result of the tremendous strides in the technological efficiency of industry which have taken place concurrently, but to take full advantage of these considerable capital expenditure is necessary and when industry is unprofitable the necessary capital is not forthcoming.
>
> If this is a true diagnosis it appears to me that the malady is too deep seated to be removed by any manipulation of currency or credit. True if it were possible to raise the price level the burden of debt would be decreased.

Lord Bradbury concludes that "any appreciable rise in the

price level above the level of world prices without reducing the gold value of the pound or abandoning the gold standard altogether is impossible."

(9) Failure of Efforts to Reduce Fictitious Wealth

All efforts to bring about the radical reduction of this huge paper wealth have failed so far to produce any adequate result. Some countries sought to reduce it through inflation, others through repayment and conversion made possible by stabilisation, others again through the drastic method of wholesale bankruptcies caused by deflation, while the most recent method was that of reflation.

None of these methods appeared to be very successful. Inflation was carried out so badly that in the long run it left most countries with an increased burden of debt. Stabilisation could not possibly be maintained for a long enough period to enable a gradual reduction of the paper wealth through repayment and conversion, and the boom it generated created new fictitious capital. Deflation carried to the extreme destroyed some fictitious capital through Stock Exchange slumps, defaults, and bankruptcies, but necessitated the creation of new paper wealth in the place of the amount destroyed, owing to the necessity of increasing the public debt through deficits and through the support granted to banks in difficulties. In any case, the fall in commodity prices increased the real burden of a large portion of fictitious wealth. Similarly, the result of reflation, especially in the United States, was an increase of public debt, in excess of the reduction of the real burden of excessive fictitious capital through a rise in commodity prices.

This experience is evidently discouraging. It raises doubts as to whether it is possible at all to reduce fictitious wealth or whether attempts to achieve that end under the existing economic and social system, whether through inflation, stabilisation, deflation or reflation, are bound to fail in the long run. We are confronted with the question whether the ineffectiveness of the methods applied was due to their inherent deficiency or merely to the manner in which they were applied. This same question will come up time after time. We shall be confronted with it when we examine the effects of the various monetary tendencies, and it will be found that the answer will be invariably the same: it is the absence of planning that caused inflation, stabilisation, deflation and reflation to show themselves at their worst. It is for this same reason that a reasonable reduction of fictitious wealth proved to be impossible.

PART I

INFLATION

CHAPTER II

WHAT IS INFLATION?

(1) The Orthodox View

The student of financial history in the year 2000 or thereabouts who tries to gather information about our period from books by orthodox economists will learn some strange things. He will be struck by the contrast between the divine wisdom and angelic goodness of the rulers of the world before the war, and the amazing stupidity or diabolical wickedness, or both, of those who were responsible for the destinies of mankind after 1914. He will be told that the wise pre-war statesmen always took good care to balance their budgets, and if they were unable to do so always took good care to cover their deficits by means of normal borrowing. Apart from a few offenders of no great consequence, mostly in Latin America or the southern part of Europe, budgetary deficits did not result in inflation and the currencies were maintained on a sound basis.

Our student will be told that from 1914 onwards, the world was governed by wicked or ignorant men who took advantage of the confusion created by the war to indulge in unbalanced budgets and plunge their countries into a reckless inflationary monetary policy. The Powers of Darkness continued to rule the world for some years after the war until they were defeated and gradually displaced by the Powers of Light, represented by the appearance of stabilisation and deflation. The victory of the Powers of Light was not, however, complete according to the orthodox chroniclers who were at pains to discover evil inflationary influences even after general stabilisation and even after prices began to slump through deflation.

(2) The Radical View

Should the student in the year 2000 derive his information from radical economic literature, he will get a totally different picture. He will be told that whatever evil consequences the war had, it certainly had one compensating advantage. It

released mankind from the bondage of orthodox financial principles. If, in the light of inflationary experience during and after the war, he is inclined to doubt whether the change was for the better, he will be told that unfortunately the newly acquired freedom of mankind from the fetters of orthodoxy was thoroughly abused; if instead of being used in an orgy of unproductive expenditure, the newly acquired financial power had been used for productive purposes the world would have attained universal prosperity. The student will be told that after the war the orthodox enemies of mankind took advantage of this abuse of inflationary powers to induce the world to submit once more to its pre-war fetters. The orgy of inflation was followed by an orgy of deliberate deflation with destructive results.

If our student in the year 2000 is endowed with a certain amount of common sense, he will doubtless realise that the truth lies somewhere between the two extremes. It is doubtful, however, whether he will realise how small was the share of human wisdom or unwisdom, goodness or wickedness in the responsibility for the inflationary or deflationary trend that occurred during the period of 1914 to 1934. The financial revolution since the war was characterised by a high degree of fatality which is not adequately realised even by our own generation. How can we then expect future generations to understand it properly? Though, perhaps, they will be in a better position to realise it, after the violent controversies which are at present raging have died down, and when it becomes possible to regard developments with dispassionate eyes.

(3) Is Monetary Policy All-Powerful?

One of the outstanding misconceptions of our times is the belief that anything that happens in the sphere of finance is a result of monetary policy. It is widely believed that monetary policy is an all-powerful weapon which can be handled according to the wish of the statesman in charge of it, and with the aid of which everything else can be governed. According to this conception, it is taken for granted that whenever there is inflation in a country its Government is pursuing an inflationary monetary policy, and that whenever there is deflation its Government is pursuing a deflationary monetary policy. In reality, in many cases, the countries drift into inflation or deflation independently of the monetary policy their Governments would like to pursue. Indeed, very often they

drift into inflation or deflation against the desperate attempts of the authorities to pursue the opposite monetary policy.

To illustrate this fact, let us give a concrete example. It is frequently stated that the French Governments before 1926 pursued an inflationary monetary policy. In reality they did nothing of the sort. Inflation was certainly going on in France until 1926, but it was going on in spite of the monetary policy of her Governments, not because of it. None of the French Governments which ruled the country between 1914 and 1926 set out deliberately to inflate. It was only with the utmost reluctance that they were compelled by the force of circumstances to take measures which led to inflation. They had to unbalance their budgets because they were unable to meet expenditure by normal budgetary resources, they had to resort to inflationary borrowing, because they were not in a position to cover the deficit with the aid of normal borrowing. Surely this cannot be regarded as the pursuit of an inflationary monetary policy. The term " policy " implies deliberate action in order to achieve a certain end. It was not the aim of the French Governments to depreciate the franc, and the steps they took which brought about that result were most involuntary. It might have been conceivable that a French Government, landed with the burden of huge war debt, and with the necessity of spending many milliards on the reconstruction of devastated areas, would decide deliberately to lighten this immense dead weight of indebtedness by depreciating the monetary unit. Nobody has ever suggested, however, that this was the case. It is a matter of general knowledge that all French Governments that succeeded each other before 1926 were decidedly anti-inflationary in their intentions, and that if they inflated all the same it was because they were not strong enough to enforce their monetary policy in face of the opposition of Parliament and public opinion to the measures necessary for that purpose.

(4) Involuntary *v.* Deliberate Monetary Movements

What is true about France holds good for most countries where inflation took place during and after the war. There were, it is true, exceptions. One of the few examples of a deliberately inflationary monetary policy is provided by the United States. The administration of President Roosevelt has deliberately adopted the policy of causing the dollar to depreciate, and raising prices. It is suggested that the German Government of 1922–3 also pursued a deliberate inflationary

policy with the object of reducing *ad absurdum* the reparations claims of the allies. It is also suggested sometimes that the Japanese Government has caused the yen deliberately to depreciate since 1931 in order to stimulate Japanese trade. Similar motives are attributed to Denmark in her depreciation of the krone. Most of these theories are open to doubt, but, in any case, it is safe to conclude that in the predominant majority of cases, inflation was involuntary, and was not brought about by deliberate monetary policy.

The same thing cannot be said to hold good to anything like the same extent about deflation. In that respect deliberate monetary policy has a much wider scope. If deflationary tendencies are contrary to the official monetary policy, the Government is usually in a position to reverse these tendencies. While resistance to inflationary trend is uphill work, resistance to deflationary trend is downhill work. An example of deflation which was the result of deliberate policy was the post-war period of 1920–1. It is a matter of opinion whether the deflation that preceded the crisis in 1931 was the result of deliberate deflationary policy on the part of some countries. Indeed, opinion is divided whether before 1929 there was any deflation at all. On the other hand the deflation that has been going on in the countries of the Gold Bloc provides a characteristic example of deflation brought about by deliberate monetary policy.

The fact that in a large number of cases important monetary tendencies originate and continue independently of the Government's intentions shows the limitations of monetary policy among the factors that govern the world's destinies. As often as not, monetary tendencies occur as a result of a variety of factors, such as the budgetary situation, the situation of the Treasury, the banking situation, general economic conditions, and even the influence of home politics and international politics.

(5) The Meaning of "Inflation"

In this particular chapter, we are concerned with the factors that bring about inflation, whether with or without the aid of the official monetary policy. Inflation is a new term in the vocabulary of the man in the street. Before the war it was unknown to all but a number of monetary economists. Although there was a slowly rising trend of commodity prices from the nineties onwards, the general public did not consider it in any way connected with the monetary factor. Even during

the early period of the war, the public was slow in realising the presence of inflation. To-day, inflation has become a household word all over the world, though comparatively few of those who use it in every-day conversation realise what exactly it means.

Expert opinion disagrees, as usual, on the definition of the term. According to a primitive conception, any increase in the volume of currency is regarded as inflation. A slightly less primitive conception regards currency in the broader sense, and includes also bank credits, thus defining inflation as an increase in the total volume of currency and credit. A more advanced definition regards inflation as an increase in the total purchasing power of the community. According to this definition the mere increase in the volume of currency and credit does not in itself necessarily constitute inflation. If an attempt is made to put money into circulation in excess of requirements, all that will happen is that the superfluous notes will find their way back to the bank. In so far as the increase in the volume of currency does not come about in such a way as to increase purchasing power, it does not create inflation. As for the increase in the volume of credit, it does not in itself create an increase in the demand for credit. It is only if solvent demand for credit is satisfied, and the expansion thus caused results in an increase in the volume of purchasing power, that it may tend to produce an inflationary effect.

All these definitions have the shortcoming of overlooking the commodities side of the problem. The more advanced definitions duly allow for any change in the volume of real wealth. Thus if the volume of currency and credit increases, and the production of real wealth increases in the same proportion, then there is no reason why the expansion of currency and credit should produce an inflationary effect, even if it affects the spending power of the community. It is only if the increase of currency and credit is in excess of the additional production of real wealth that it is defined as being of inflationary character. The so-called quantity theory of money is based on this fundamental truth, though it is elaborated and complicated by allowing for the velocity of circulation of the currency. This complication is entirely unnecessary once it is admitted that an expansion of the volume of currency and credit can only produce inflationary effect through increasing purchasing power, and that an increase in purchasing power can only produce inflationary effect if it is actually being used for purchase. The inflationary effect of an increase of pur-

chasing power depends upon the degree to which the public spends its earnings. The ratio between spendings and savings fluctuates widely, especially if the predominant majority of incomes is in excess of the subsistence level.

(6) Inflation of Currency and Inflation of Prices

In talking about inflation, it is also necessary to discriminate between inflation of currency and inflation of prices. In the majority of cases, inflation assumes the form of inflation of currency, which means that the expansion of currency and credit through its effect upon active purchasing power brings about a rise in prices. Situations may arise, however, in which the rise in prices precedes the expansion in the volume of currency and credit. This occurs especially during advanced stages of inflation when a further rise in commodity prices is anticipated, and from time to time the volume of currency and credit becomes inadequate to meet requirements increased through the rapid rise in commodity prices.

Inflation of prices may occur also in less abnormal conditions. It is possible that prices are raised not through any expansion of currency and credit but through an external factor, such as the devaluation or depreciation of the exchange value of the currency. Such action causes a rise in the prices of imported commodities, which may be followed by an all-round rise of commodity prices. This is what happened immediately after Great Britain suspended the gold standard in 1931. In this case, however, the rise proved to be short-lived because deflationary monetary and financial measures prevented the volume of currency and credit from adjusting itself to the higher price level, and as a result it was the latter that adjusted itself to the former.

We said above, that the mere increase in the note issue is not in itself inflation. Apart from any other reason, it is necessary to allow for hoarding. In the case of France, the note issue increased considerably during the years of the crisis, but it is doubtful whether the rise affected at all the actual volume of notes in active circulation, for some twenty-five milliard francs of notes have been hoarded, and do not, therefore, constitute part of the active note issue. In any case, the increase in the note circulation does not necessarily create additional purchasing power. If a Government loan were to be repaid in cash on maturity instead of being converted, the increase in the volume of currency would not necessarily affect commodity prices. It would not constitute additional

purchasing power, and would not, therefore, tend to increase the demand for commodities in general. What it would do would be to increase demand for various forms of investment, and thus tend to raise the price of securities, and possibly of real property. In that sense, its effect may be said to be inflationary.

(7) Cheap Money and Inflation

Cheap money and plentiful credit supplies are not in themselves inflation. It is necessary to discriminate between the volume of credit available and the volume of credit actually used. Just as the increase in incomes does not itself necessarily lead to an increase of spending, so the increase in the volume of credit does not itself necessarily lead to an increase in the actual employment of credit. Indeed, while the chances are that to some extent, at any rate, the increase of incomes will lead to increasing spending, the larger volume of credit available does not itself add to the active volume of credit. In times of feverish business activity, when all credit facilities are employed to the limit, then the creation of additional credit facilities is likely to lead to actual credit expansion. During periods of trade depression, however, cheap and plentiful credit facilities do not in the least tempt potential borrowers to increase their loans. This fact is generally overlooked by the advocates of cheap money and by its opponents. They do not adequately realise that producers and merchants do not borrow merely because they can do so easily and cheaply, but only if they have reason to hope that they will be able to increase their sales. Cheap and plentiful credit does not in itself create markets for them, and does not in itself induce them to increase their output or their stocks. If the creation of additional credit facilities leads to the increase in the volume of active credit, then it may produce inflationary effects.

(8) Inflation through Budgetary Deficit

A way in which inflation often comes about is through a budgetary deficit. By spending more money than it withdraws in the form of taxation, the Government increases the volume of potential purchasing power in the hands of the public. This is the case especially if the deficit is covered by means of an increase in the volume of currency. If it is covered by means of normal borrowing, it tends to increase active purchasing power to a much less extent, for while it increases potential purchasing power on the one hand, it creates

also a transfer into savings of amounts which would otherwise have been spent. In fact, it is only if the public is prepared to increase the proportion of savings to total purchasing power by acquisition of additional Government bonds that the Government is in a position to cover its budgetary deficit by means of normal borrowing. We must not, however, be too dogmatic on this point, since part of the capital may come through sale of existing investments ; although somebody has to buy securities thus sold, the fall in their price reduces the amount thus diverted from spending to saving.

The increase of incomes brought about through budgetary deficit does not in itself necessarily lead to an increase of spendings, since it may be accompanied by an increase of savings. The chances are, however, that, to a large extent, the potential purchasing power thus created will become active purchasing power and will thus produce inflation. The degree of this inflation will depend upon the extent to which this increase in the active purchasing power is accompanied by an increase in the volume of real wealth produced, and also to the extent to which the real wealth produced corresponds to the requirements of purchasers. The expansion of purchasing power will produce its maximum effect if production is prevented from adjusting itself to the increased requirements of consumers, and if, in fact, productive capacity is reduced. This is what actually happened during the war, and to some extent also during the early post-war years. It is this particular phenomenon that we propose to examine in the next two chapters.

CHAPTER III

FINANCE BEFORE AND AFTER 1914

(1) Inflation Before 1914

As most people had never heard of inflation until the war, it is a widespread belief that inflation did not exist in modern times, at any rate, until 1914. While people of average education must have had some vague recollection of what they had learnt or read about John Law and the experience of the French Revolution and of the American Civil War, these were considered past history. Those who gave the matter a thought at all before the war probably believed that our generation was above that sort of thing, at any rate, as far as the well-established countries were concerned. It was understood that some Latin-American country might sink so low as to offend against the canons of sound finance, but such behaviour was unthinkable in Western Europe. And yet a slow but persistent inflation was actually going on all over the world during the two decades or so that preceded the war. From about the middle of the nineties, prices were rising all over the world, and apart from two relapses caused by cyclic crises they continued to rise slowly until 1914. The inflationary character of the rise was far from obvious, but its coincidence with the sudden increase of monetary resources as a result of the influx of South African gold cannot be ignored. It is more than probable that the rising trend of prices was the direct consequence of the monetary expansion caused by the increase in the world's monetary stock of gold.

It is true that even before the war the number of Governments whose budgets were balanced was none too large. As a result of the accumulating deficits, public debt was increasing steadily, although in the light of the astronomic figures we have become accustomed to since 1914, the rise may be considered moderate. There is no reason to believe that in most countries these budgetary deficits were to any extent a contributory cause to the rising trend of commodity prices. After all, the accumulation of savings in most countries was in excess of budgetary deficits, so that

it rather more than offset the creation of new potential purchasing power. Moreover, a large proportion of the amounts spent by the Governments served the purpose of constructing new railway lines and other means by which the active purchasing power was absorbed. It is true that in Europe, at any rate, the increase of public debt was largely the consequence of armament expenditure. To that extent, it was decidedly of an inflationary character.

(2) Increase of Purchasing Power

To some extent at any rate the rise in prices was due to the upward trend of wages before the war. In most countries, the working classes were just beginning to make themselves felt as a political factor, and their organised efforts led to a gradual increase of wages. This increase was, however, inferior to the rise in wholesale prices, so that it could not have been the only cause of the upward movement.

The way in which the increase in the monetary stock of gold brought about a slowly rising trend of commodity prices was probably through bringing about an expansion of currency and credit. Although no figures are available, it is beyond doubt that the volume of gold coins in circulation increased during the decades before the war. The development of modern banking resulted in a world-wide increase in bank deposits and credit facilities, causing a slow but steady industrial and commercial expansion. This again created additional purchasing power through increased earnings. There was inevitably a time lag between the creation of additional purchasing power and the creation of additional real wealth, and during this transition period, which was in reality continuous, prices adjusted themselves in an upward direction.

The state of affairs was totally different in comparatively new countries which had to make large capital expenditure in order to accelerate their development. In these countries, the Governments had perpetual deficits attaining comparatively large figures. What is more, the funds required for meeting the deficits were supplied mostly by foreign lenders. In so far as they were not spent on goods produced abroad, they increased the purchasing power of the public in the countries concerned, and brought about inflationary tendencies which were largely responsible for the depreciating trend of the currencies of these countries. Actually, inflation from an increase in the volume of currency to meet the deficit was exceptional.

(3) Fallacy of Financial Limitations of War

So far as Western and Central Europe were concerned, the conception of fundamentally sound monetary principles was well-established. If there were occasionally proposals to accelerate development by pursuing a less orthodox policy they were not taken seriously. The idea that monetary resources could be artificially increased by inflationary means did not occur to most people. For this reason, it was believed that no modern war could possibly last more than a few months, owing to the limitations of financial resources. The idea that these financial resources could be multiplied and that through the operation of a vicious circle they could be spent over and over again by the Governments, would have been treated as an absurd heresy had anybody ventured to put it forward.

Although history taught that wars often result in inflation and are financed by inflationary means, the pre-war generation had no such experience and took it for granted, on the outbreak of the war in 1914, that this war would be financed on orthodox lines. Knowing as they did that the financial resources of the various countries were limited, they assumed that, once those resources were exhausted, the war would have to come to an end.

Hence the prophecies in August 1914, by experts whose opinion carried weight, that owing to the limitations of the financial resources of all countries, the war could not last more than two months or so. Hence the optimistic forecast on the part of the Allied experts that, as the war was bound to be won by the party which had the last shilling in his pocket, an Allied victory was a certainty. The Allies did win the war, but the superiority of their financial resources, and their access to the financial resources of the United States, had relatively little to do with it. Before many months it became evident that, somehow or other, it was possible to finance the war ; although the belligerent countries had already spent many times the amount which in August 1914 was estimated to be the limit of their resources, they were none the less able to carry on. It was discovered that, strictly speaking, there was no such thing as a limit to the financial resources available for financing the war. The modern system of currency and credit has done away with the limitations which were imposed upon statesmen before the advent of the modern era.

Even in mediæval days, when armaments had to be paid for in hard cash in the strictest sense of the term, wars could drag on for thirty years and for a hundred years, notwithstanding the limitation of cash resources and the absence of the Printing Press. In modern times, when payments can be made, internally at any rate, by printing more and more notes, the financial limitations of a war are practically non-existent. It is true that currency depreciation has its limits. We have seen that in 1923 a stage was reached in Germany when inflationary methods ceased to assist the Government in covering its public expenditure for the simple reason that the mark notes printed ceased to have any value. It took, however, five years after the cessation of hostilities to reach that stage. But for reparations payments, internal political troubles, and the desperate policy adopted at the time of the Ruhr invasion, that stage of utter demonetisation of the currency might never have been reached, or at any rate it would have taken a much longer time to reach it. It is reasonable to assume that, so far as purely financial considerations were concerned, Germany would have been able to continue the war for at least another four years, and possibly a good deal longer, before financing armament by inflationary means had reduced itself *ad absurdum.*

(4) Increase of Fictitious Wealth

While before the war General Staffs and War Ministries had to struggle for every additional penny of armament expenditure, during the war the sky was the limit for the amount placed at their disposal. The whole financial conception of the world seems to have changed in 1914. Admittedly, before the war there was a slow but steady expansion of fictitious financial resources. In spite of this, it may be said that at any given moment the limit of those resources was comparatively rigid, so that any additional expenditure on armament had to result in a corresponding curtailment of expenditure in other directions. During the war these formerly rigid limits suddenly became elastic in the extreme. There was no longer any question of trying to make up for additional armament expenditure by curtailing public spendings elsewhere. Indeed, to do so would have been impossible, since in most countries the cost of the war was a multiple of the entire remainder of the budget.

In the circumstances the inevitable result of financing armament expenditure was an expansion of fictitious wealth and

the creation of fictitious purchasing power. Before the war the increase of real wealth through the improved exploitation of natural resources, and the construction of capital goods and consumption goods, kept reasonable pace with the expansion of fictitious wealth. During the war, however, the enormous increase of fictitious wealth created by excessive expenditure on armaments, together with other factors such as the limitation of production or the destruction of real wealth, was not accompanied by an increase of real wealth. On the contrary, while between 1914 and 1918 the fictitious wealth of the world as represented by holdings of notes, Government bonds, banking deposits, shares, etc., became multiplied, the real wealth actually declined.

(5) An Unconscious Change

Evidently there was a fundamental change in the attitude of governments towards finance in 1914. Notwithstanding this, if anyone had suggested in August 1914 that what was happening was a revolutionary development in the sphere of monetary policy, few people would have believed him. The change took place without the public or the authorities duly realising it. In fact, the attitude of the authorities and of public opinion towards the financial aspects of the war was characterised during the early period of the war by an utter lack of realisation of what was taking place. The simplified version of financial history which will probably be generally accepted by future generations will regard 1914 as the landmark between orthodox and unorthodox monetary policy. For the generation that witnessed the change, the landmark was invisible. It was obvious that the outbreak of hostilities necessitated abnormal expenditure, but few people realised that this expenditure would, in the long run, result in changes of fundamental importance.

With our superior knowledge, we may be tempted to condemn the statesmen and economists of 1914 for not having grasped the meaning of the change. In reality, it was by no means easy for them to realise the immense consequence of the war in the sphere of finance. First of all, it was taken for granted that the war would not last more than a few months. Had this assumption proved correct, probably there would not have been a fundamental change in the world's financial policy. The comparatively moderate expenditure of a three months' war could have easily been financed through an increase of the public debts in all countries and through

higher taxation. Had the war ended in November 1914, it is highly probable that the world would have returned to financial orthodoxy whence it departed in August 1914.

The teachings of modern history were also in favour of the assumption that the war would not cause any fundamental change in financial policy. The Crimean War left the currencies of Great Britain and France unaffected. After the Franco-Prussian War, in spite of the complete defeat of France, the internal upheaval and the heavy reparation payments, the depreciation of the franc never exceeded 3½ per cent. The South African War left the pound unimpaired, and the currencies of the Balkan States were hardly affected by the war of 1912. It appeared reasonable to assume, therefore, that the World War would produce no abnormal effects upon the monetary situation. Indeed, it was this assumption that governed the financial policies of the various belligerent and neutral countries, not only at the beginning, but also during the more advanced stages of the war, when it was becoming increasingly evident that the struggle would continue for a long time.

(6) The Mistake of August 1914

This erroneous assumption was largely responsible for the taking of a number of mistaken measures and for the omission of a number of right measures. The most typical example of the former type of error was the increase of the bank rate to 10 per cent by Great Britain in August 1914. It was characteristic of the bank rate worshipping mentality of pre-war economists and bankers which to a high degree survived even during and after the war. According to the orthodox dogma, the bank rate is an all-important weapon with which central banks are in a position to govern the welfare of the nation, the fate of mankind and even the course of the Universe. According to this conception, bank rate could cope with any emergency if it were raised to a height proportionate to the degree of the emergency. If the Baring crisis was overcome with a bank rate of 6 per cent, it was assumed that the war crisis could be solved with a bank rate of 10 per cent. Had Great Britain been invaded by the enemy during the war, the bank rate would probably have been raised to 15 per cent; had she been ravaged by revolution and civil war, the bank rate would have been put up to 20 per cent, and had an earthquake threatened to swallow the British Isles the obvious remedy that orthodox bankers and economists would probably have

advocated would have been to put up the bank rate to 30 per cent. And had the astronomers discovered that another planet was threatening to collide with our globe the pundits of pre-war finance would have expected to avert the disaster with the aid of a 100 per cent bank rate. The violent attacks directed against the British authorities for having failed to raise the bank rate sufficiently during the crisis of 1931 were the survival of this absurd conception. However that may be, the 10 per cent bank rate certainly failed to cure the crisis of 1914, indeed, it aggravated the troubles to no slight extent. The superiority of the organisation of the London market and of the nerves of the British public were of no avail in face of such brutal panic measures of the authorities. It is indeed absurd that while in Germany with her more primitive financial system it was considered sufficient to raise the bank rate by one per cent, the Bank of England deemed it necessary to raise it by 7 per cent. The result was the accentuation of the panic and an utterly unnecessary dislocation of the international money market, without the least beneficial effect to anyone.

(7) Financing War Deficit

The British authorities of 1914 evidently failed to realise that the emergency created by the war was not merely a cyclic crisis, and should not be handled as such. After their recovery from the first shock, they were able, however, to realise the significance of the changed situation. Among all the belligerent countries, Great Britain was the only one to make a serious effort to finance at least part of the expenditure by means of increased taxation. All other countries left taxation practically unchanged until the second half of the war, and even then increased it barely sufficiently to cover ordinary expenditure.

Unquestionably, the British attitude was in accordance with the generally accepted principles of sound finance. While it was impossible to raise by means of taxation the whole of the extraordinary expenditure, the British Government went as far in this direction as it was practicable. On the other hand, the continental belligerent countries assumed that since the war expenditure was beyond their means, it would be futile to attempt to balance it by normal methods.

Neither the British Government nor the continental Governments realised, however, that the gigantic expenditure would make a change in the value of their currencies inevitable. The

difference between the British and continental attitude was that while the British Government did its utmost to fight against the inflationary tendency without realising its significance, the continental Governments did not even attempt to tackle the task.

The change of 1914 took place almost unnoticed. With the exception of a few economists, nobody realised its true significance until much later. The word "inflation" did not become popular until the last year of the war, long after the world had begun to feel its effects.

CHAPTER IV

WAR FINANCE

(1) World-Wide Tendencies

THERE is a striking similarity between the financial history of most countries during the war. The same phenomena manifested themselves all over the world, with differences only in their degree. All the Allies and Central Powers, big countries and small countries alike, were subject to the same tendencies which affected to some extent even neutral countries. There was in the first place, the immediate increase in public expenditure that followed the outbreak of hostilities. Mobilisation of armies of a size which was entirely without precedent required large disbursements during the first days of the war. None of the Treasuries was adequately prepared to meet the requirements out of its reserves. Experience of the war dispelled among many other legends that of the proverbial war chests which in the imagination of the uninitiated were supposed to be sufficient to finance the war, at any rate during its early stages. Whether or not there was some truth in the popular belief that the German Government retained in the vaults of Potsdam a large portion of the French indemnity of 1871 in the form of gold, it is certain that from the very outset, the resources of the German Treasury had to be supplemented to meet requirements. Even neutral countries had to resort to large abnormal expenditure and endeavour to defend their neutrality against possible attack.

The increase of war expenditure was not accompanied by any reduction in ordinary expenditure. On the contrary, with the rising prices, ordinary expenditure was also increased, apart altogether from the necessity of financing the various forms of state intervention in the economic sphere and various forms of social assistance that had become necessary during the war. Apart from Great Britain, there was barely any other country which was able to cover at least ordinary expenditure out of normal budgetary receipts. There was a large deficit in every country, whether belligerent or neutral.

(2) Difficulty of Normal Borrowing

Another circumstance which was world wide was the impossibility of covering budgetary deficits out of loans, especially during early stages of the war. The shock caused by the declaration of hostilities disorganised completely the financial markets and made it impossible for several months to attempt to raise any Government loans in the usual way. Indeed, such was the confusion at the beginning that it was difficult even to maintain normal financial activity. In most countries it was considered necessary to introduce moratoria and various other panic measures, some of which proved to be superfluous, and only accentuated the confusion. In the circumstances, there could be no question of covering the deficit by normal borrowing and the Governments had no choice but to make use of the Printing Press from the first day of the war.

During more advanced stages of the war, the financial markets recovered gradually from the first shock, and it became possible to issue Government loans for the financing of the deficits. In fact, as a result of the expansion of monetary resources, the funds available for Government issues increased considerably. They were from time to time absorbed by Government issues, but before long as a result of budgetary deficits the funds returned once more to the public.

In addition to this vicious circle there was another vicious circle. In order to encourage subscription to war loans, in every country the central banks had undertaken to grant advances up to a certain percentage of the amounts. As a result, many people subscribed more than they could carry out of their own resources, and financed the difference by borrowing from banks or from the central banks. As a result of the operation of these two vicious circles, the Governments had never been able to absorb the surplus currency created for any length of time. The note circulation went on increasing almost uninterruptedly throughout the war in every country.

(3) Increasing Purchasing Power

Another phenomenon which was noticeable in every country, belligerent and neutral alike, was the increase of the purchasing power of the public through budgetary deficits. It was through this increase in purchasing power that war-time inflation produced its effect upon prices. The majority of economists maintain that the effects of the increased note circulation and to a lesser extent of the expansion of credit were responsible

for inflation, and that had it been possible to cover the deficit by means of normal borrowing, there would not have been any inflationary effects produced. In reality, there could be no question of covering the whole amount of the deficits by the issue of loans, for as a result of the deficit the earnings of large classes of the population had increased and it would have been impossible to compel them to save and invest the whole surplus instead of spending at least part of it. Admittedly, had the note circulation been rigidly kept down to its pre-war figures, inflation could have been reduced considerably. But in face of the urgent necessity of spending to meet the war requirements, it was impossible to keep the note circulation down.

Yet another international phenomenon was the reduction of commodity supplies available for consumers. In every belligerent country the goods available for normal consumption became reduced considerably through a series of circumstances which are too well known to require detailed discussion. Even in neutral countries increased purchases by belligerent countries together with the limitation of the means of transport, blockade, submarine warfare, etc., produced such scarcity of commodities. Thus at the same time as additional purchasing power was placed in the hands of the public, the possibilities of making use of this purchasing power became drastically curtailed.

(4) Why Rise in Prices was Slow

How was it that notwithstanding this the rise in prices was relatively moderate, especially during the earlier stages of the war? This can be explained by two sets of circumstances, both of which were of a universal character. The first was the failure of the public all over the world to grasp the meaning of the inflationary tendencies. The second was the system of price control and rationing.

We pointed out in the previous chapter that the authorities of various countries failed to realise the significance of the war from the point of view of its effect upon the monetary situation. If the Governments were unable to realise what was going on, it is not surprising that the general public was not in a position to grasp the meaning of the change. In the absence of any inflationary experience for some generations, the public did not realise for some time that the budgetary deficits were bound to bring about a rising trend of commodity prices. There was no anticipation of such a rise, and during the earlier stages of the war, prices advanced only gradually. Later when inflation

reached a more advanced stage, and when both producers and consumers were inclined to anticipate a further rise, the authorities countered it by introducing price control and rationing. As a result, the public was prevented from making full use of the additional purchasing power it obtained, and prices did not rise in proportion to the degree of inflation.

Unquestionably, the ignorance of the public proved to be a blessing for the Governments of the belligerent countries, since it greatly facilitated their task. Had the world entered the phase of war inflation in 1914 with its knowledge of 1920, it is certain that prices would have soared more rapidly from the very first day of the war, and that inflation would have made a much more rapid progress.

(5) No Wholesale Flight of Capital

The same ignorance that obviated a too rapid rise in commodity prices all over the world was also responsible for the absence of any wholesale flight of capital from the belligerent countries. Had the public realised the monetary effects of war finance, no patriotic considerations would have prevented an exodus of capital to neutral countries. As exchange control was practically non-existent at the beginning of the war—even in 1918 its methods were relatively primitive—such a flight of capital would have reduced the exchange value of the currencies of the belligerent countries to a fraction of their mint parities and would have greatly increased the difficulties of the Governments in making purchases in neutral countries. Here again, the ignorance of the public proved to be a blessing, from the point of view of war requirements.

There was, indeed, relatively little flight of capital between 1914 and 1918. A certain amount of capital took flight to Switzerland from the Central Powers and from France, while some French capital found its way to London and New York. The total amount involved could not have been, however, very large. There was no flight of capital from Great Britain; indeed, with the aid of paying special deposit rates, the British authorities managed to attract considerable funds from neutral countries, notwithstanding the exchange risk, the existence of which was temporarily concealed by the policy of exchange pegging pursued by the Allies.

(6) Exchange Control

This policy of exchange pegging was again a phenomenon that existed in many countries during the war. Allies and

Central Powers alike endeavoured to counteract the depreciating tendency of their exchange by various methods of exchange control such as intervention, exchange restrictions, import restrictions, etc. The foreign exchange markets failed to register the tendencies affecting the various exchanges owing to these artificial measures. The extent of the depreciation of the currencies was disguised internally by price fixing over certain commodities and by rationing, while it was concealed internationally through exchange control to an increasing degree.

Another measure that was applied by all European belligerent countries was the mobilisation of privately owned resources required for purchases abroad. In the first place, every Government endeavoured to increase the amount of the gold reserve. To that end the export of gold was prohibited everywhere, and the convertibility of the notes was suspended in law or in practice from the first day of the war. In other words, the belligerent countries suspended the gold standard so as to avoid losing their gold. Even the United States, notwithstanding the large increase of her gold stock during the period of her neutrality, considered it necessary to place an embargo on gold exports in September 1917. The European belligerent Governments went, however, further by organising patriotic collections of gold. In various countries, the Government appealed to the public to surrender its gold coins, jewels, etc., either against payment of the statutory buying price or simply as a patriotic gesture in return for some token. By such means, various Central Powers succeeded in increasing their gold reserves during the first three years of the war in spite of the necessity of exporting gold in payment for goods or in support of the national exchange. In Germany in particular, the gold reserve was more than doubled in three years. The willingness of the public to surrender their gold holdings was also partly due to their ignorance of the coming depreciation of currencies. Had they been aware that the depreciation would become accentuated after the war and that in many cases it would become perpetuated through devaluation, the degree to which they responded to patriotic appeals would probably have been much less.

(7) Mobilising Foreign Securities

In addition to the mobilisation of privately owned gold supplies, the Governments of several belligerent countries resorted also to the mobilisation of privately owned foreign securities. At first, they endeavoured to obtain such securities

by purchase in the open market or by appeals for voluntary surrender. Subsequently, when requirements for making payment abroad were becoming more pressing, they had to resort to more drastic methods, either in the form of a special tax on foreign securities, which was applied in England, or by making the surrender of such holdings compulsory which was done in France and Germany. The securities thus mobilised were, for the most part, repatriated to the debtor countries. This was decidedly a sound movement, since before 1914 Europe had accumulated excessive claims on the four other continents. Unfortunately, owing to the prolonged war, the pendulum swung in the opposite direction, and by 1918 Europe was as heavily indebted to the United States and other overseas creditors as they had previously been to her.

These are points in which the financial histories of various countries showed a high degree of singularity. Any difference there was between them was mainly one of degree. There were, on the other hand, many points on which conditions differed fundamentally in various countries. The extent to which various belligerent countries were able to finance the war without any external assistance differed considerably. Great Britain, France and subsequently the United States had to grant substantial support to their financially weaker allies. Similarly, Germany granted a certain amount of assistance to the financially weaker Central Powers. The neutral countries accumulated gold stocks and granted substantial credits to the belligerent countries. Their exchanges went to a substantial premium against those of the European belligerent countries, and even against the dollar after the entry of the United States into the war. While war-time production and consumption of a non-military character was limited in the belligerent countries, it increased considerably in neutral countries which enjoyed an unprecedented era of prosperity.

(8) The Degree of Inflation

The degree of inflation differed widely in the various countries. Although war-time prosperity increased considerably the purchasing power of the neutral countries, their prices rose to a relatively less extent, partly because their supplies of commodities were more plentiful than those of the belligerent countries, and partly because confidence in their currencies was greater. This latter factor is of great importance. The same degree of inflation produced a different degree of effect according to the degree of confidence in the currency concerned.

Another reason why price levels in the neutral countries rose to a less degree than in belligerent countries was the firm tendency of their exchanges, brought about by their favourable trade balance. This view is in contradiction to the popular purchasing power parity theory of exchanges which holds that exchange rates are determined by the relative price levels in the countries concerned. This may frequently be the case, but as often as not, it is price levels that are determined by exchange rates which in turn are determined either by the balance of trade or by some other outside factor. The neutral countries supplied goods to the belligerent countries not because their prices were cheaper, but because the belligerent countries had to make purchases in the interests of the successful conduct of the war. These purchases could not be altogether counteracted through the export of gold and foreign securities, and hence they were bound to cause an appreciation of neutral exchanges against belligerent exchanges. As a certain amount of commodities was being exported from the belligerent countries to the neutral countries, the result of this exchange movement was bound to influence to some extent the price level of the latter in a downward direction.

(9) Deflationary Policy in Great Britain

Apart from the neutral countries and the United States, inflation attained the most moderate degree in the United Kingdom. This was due to the deflationary monetary policy pursued by the British Government amidst inflation. This policy manifested itself in the increase of the bank rate, which was maintained at a relatively high average level during the war, even though its increase to the fantastic level of 10 per cent did not last long. The system of special deposit rates was also calculated to mop up as much floating capital as possible, even though its original object was to attract foreign deposits. Last, but by no means least, high taxation had a certain share in keeping inflation down. About 20 per cent of war expenditure was covered by current taxation, while in Germany the proportion was only 6 per cent, and other belligerent countries were unable to cover even their ordinary expenditure. The reason for this difference was, in the first place, the exceptional loyalty and discipline of the British taxpayer. Apart from this, the fact that at the beginning of the war Great Britain was the only country where direct taxation played an important part had also a great deal to do with it. It was impossible for other countries to develop at short notice a

system of direct taxation comparable to that of Great Britain. Nor was it possible to increase to any large extent indirect taxation, since it would have caused an immediate rise in commodity prices, which was exactly what the Governments were anxious to avoid.

In France and Germany, the degree of inflation was kept within relatively moderate limits. In Germany at the time of the Armistice, the note issue per head of the population was four times its pre-war figure. Allowance is to be made, however, for the fact that German notes were circulating largely in occupied countries, though in some cases local currency was issued by the occupation authorities. Commodity prices in Germany were at the time of the Armistice about 2½ times their pre-war figure, while the exchange value of the mark had declined by about 50 per cent. In France, the note circulation doubled during the first year of the war, which was not surprising since the enemy invasion paralysed the fiscal system over the most prosperous districts of the country. Strangely enough, the franc remained at a premium over both sterling and dollar throughout 1914, in spite of the invasion of a large part of France. The premium would have been higher but for the official French buying of sterling and dollar. In 1915 the franc went to a discount, but was well maintained throughout the war, thanks to British and American credits.

The Italian lira, the Austro-Hungarian krone and the Russian rouble together with the currencies of the smaller belligerent countries depreciated to a higher degree than either the mark or the French franc. Even their depreciation, however, remained well controlled until the day of the Armistice. Although inflation in these countries attained a high degree, it was not until after the cessation of hostilities that it manifested itself to its full extent, and even to an exaggerated extent, through a rise in prices and a depreciation of the exchanges.

CHAPTER V

WAR FINANCE (CONTINUED)

(1) World-Wide Inflation

The cessation of hostilities in November 1918 found the world amidst the biggest movement of international inflation that has ever yet occurred. The only historical example which can be compared with the inflation that had taken place during the war was the gold inflation that followed the discovery of America. Our knowledge of the exact conditions of inflation during the Sixteenth Century is inadequate to enable us to compare the extent of that movement with the inflation of 1914–18. In any case, conditions in the Sixteenth Century were relatively primitive, so that there is very little common ground for comparison. Nor can war-time inflation be compared with the inflationary experiences of various continental countries and of the United States during the Eighteenth and Nineteenth Centuries. All these inflationary movements were essentially of a national character. During the Napoleonic Wars there was, it is true, an inflation that extended practically over the whole of Europe, but the other continents remained immune from it. It is only since the end of the Napoleonic Wars that international trade and finance have developed to an extent that renders inflation of a truly international character possible, and in given conditions even inevitable.

Volumes have been written about the destructive effect of war-time inflation. The horrors of a depreciating currency with all its repercussions upon every branch of economic, political and social life have been painted with vivid colours by innumerable authors. Anyone attempting to minimise the destructive effect of inflation during the war runs the risk of being classed in the same category as warmongers. And yet for the sake of historical truth it is necessary to re-examine dispassionately the effects of war-time inflation. Most of those who have written on the subject have been either under the immediate influence of the developments, or have regarded war-time inflation in the light of post-war inflation, or else

have been guided by the desire to make out as strong a case as possible against inflation by painting the darkest possible picture of its consequences.

(2) Need for Discrimination between Effects of War and of Inflation

In reality, war-time inflation was not nearly as destructive as many economists would like us to believe. In order to be able to form a clear judgment, it is necessary to discriminate between the effects of inflation itself and those of other factors. First of all, shortage of food and other commodities was not an effect of inflation, but a cause of it. It was the result of blockade, submarine warfare, the increased requirements of national defence and the reduction of the productive capacity of the nations. Even if the war had been financed with strictly orthodox methods, it would have made but little difference from the viewpoint of the total volume of commodities available for consumption by the civilian population. It is true that inflation reduced the purchasing power of certain classes and increased that of other classes. The degree of the changes was, however, comparatively moderate during the war. In almost every country rent control was introduced, which meant that a most important item in the cost of living was not allowed to rise. The price of food representing primary necessities was also controlled, and within the limits of the official rations it was possible to satisfy requirements at comparatively low prices. The reduction in the standard of living during the war caused by inflation was, therefore, relatively moderate, even for the classes which were affected by it to the largest extent.

It is necessary to discriminate between the effect of inflation and that of inevitable war expenditure. Had it been possible to finance the war without having to inflate, the public debt of all countries would none the less have undergone a spectacular increase. Admittedly, the increase would not have been nearly as marked as it was, since war expenditure was increased by higher prices, especially during the advanced stages of the war. Possibly, instead of having to spend some seven milliards on the war, Great Britain would have had to spend only, say, five milliards if prices had remained on their 1914 level. But this difference of two milliards cannot be accounted for entirely as being the result of inflation. To a very large extent the rise in prices was due not to an increase in the volume of currency and credit, but to shortage of commodities, which, as we said

before, was not the consequence of inflation. In particular, in neutral countries, inflation was the effect and not the cause of the increase in commodity prices. The cause was the abnormal purchases for the belligerent countries.

(3) Currency Depreciation Inevitable

Above all, given the fact of the spectacular increase of public debts, it was inevitable that the currencies should depreciate. In most belligerent countries, the public debt increased between 1914 and 1918 by at least a thousand per cent. It was unthinkable that such a tremendous burden should be borne permanently on the basis of the pre-war value of the currency. Such a burden would have been beyond the taxation capacity of most nations. The only way in which that burden could possibly be reduced without having to commit an act of State bankruptcy was through the depreciation of the monetary unit. About this aspect of the problem, a great deal will be said in later chapters. Here let it be sufficient to point out that given the fact of the inevitable necessity of huge war expenditure, the depreciation of currencies became unavoidable. From this point of view, war-time inflation tended, in fact, to solve the problem created by war expenditure.

Notwithstanding all this, it must be admitted that war-time inflation was decidedly destructive, even though not nearly to the extent claimed by orthodox economists. Even in countries where inflation was not allowed to go very far during the war, it undermined the financial strength of the middle classes. The persistence of the rise in prices created a dangerous speculative mentality manifesting itself in indiscriminate production and acquisition of stocks; in the appearance of unnecessary middlemen; in hoarding commodities; and in an altogether demoralised atmosphere in industry and trade. The possibility of making profits easily stimulated greed in every class of the population, and brought out the most undesirable qualities in human character. There are innumerable other arguments which could be marshalled to prove that war-time inflation was destructive.

(4) Unproductive Inflation

To some extent evil consequences are unavoidably connected with inflation. To a very large extent, however, they were due to the circumstances in which inflation took place. The possibility of making profit by indiscriminate production and acquisition of commodities was due only to a small extent

to the rising trend of prices. To a much larger extent, it was the consequence of the urgency of war requirements and of the restricted supplies of commodities. In all belligerent countries, the military authorities made their purchases in great haste, and without much regard to quality and price. This, together with the fact that the increase of demand was unable to cause a corresponding increase of supply, was mainly responsible for profiteering. Admittedly, a slow increase in the price level is in itself calculated to encourage indiscriminate production and commerce. In the absence of economic planning, a rising trend in prices is always bound to cause dislocations through lack of discrimination in increasing production and stocks. From this point of view, conditions during the war were not quite as anarchic as they were after the war, for production was planned to a certain extent in accordance with the requirements of national defence.

The main reason why inflation during the war produced unfavourable effects was that the expenditure through which it occurred was made for unproductive purposes. The expenditure was unproductive from a point of view of social utility. Technically for every pound spent on armament, goods were actually created. We need not examine whether it was the case that, through extravagance or incompetence, the various Governments spent a good deal more than they ought to have done on the equipment of their armed forces. What matters from the point of view of our argument is that, by increasing fictitious wealth, it was possible to produce guns and ammunition, uniforms and all the innumerable other articles required by the armies, which could not possibly have been produced if the limit of expenditure had been kept as rigid as it was before the war. It is true that all those products had no economic value. They were used up and destroyed in the struggle between the nations. This does not, however, alter the fact that it is possible to increase the production of goods by creating fictitious purchasing power.

(5) Would Productive Inflation have been Possible?

Just let us try to visualise for a moment what would have happened if, instead of spending untold milliards on armaments during the war, all the countries involved had spent an identical amount on productive expenditure. What immense real and permanent values could have been added to the wealth of mankind! All nature's resources could have been made available for the consumers whose standard of living could have been

raised to the highest level imaginable. All nature's resources of energy could have been harnessed and placed at our disposal, making it possible to reduce working hours to a figure which is beyond the dreams of the most optimistic Utopian. If all the money and human labour spent on the construction of trenches and other defences had been employed for constructive purposes, the whole population could be housed in palaces instead of slums.

It is tempting to indulge in such futile speculation of what might have happened. In reality such a situation could not possibly have arisen. But for the war, the mentality of the world would have remained strictly orthodox. No Government would have departed from sound financial principles for any other purposes than for the defence of the nation against enemy aggression. What is more, it might not even have been desirable to launch into public expenditure, however productive, on such a gigantic scale. Paradoxical as it may sound, it would have destroyed prosperity instead of increasing it. It ought to be borne in mind that *laissez-faire* reigned supreme before 1914. This means that the sudden increase in the utilisation of natural resources and productive forces would merely have resulted in over-production on an unprecedented scale, and unemployment through the replacement of human labour by hydro-electric and other natural forces would have run into fantastic figures. In the end, instead of enjoying ideal prosperity, the world would have witnessed a terrific economic collapse compared with which the economic crisis of 1931–4 disappears into insignificance. In the complete absence of economic planning, it was perhaps as well that orthodox financial principles prevented such an orgy of expenditure for productive purposes.

(6) Ill-Considered Emergency Measures

Returning from the realm of speculation to that of realities, it is evident that both unorthodox spending and the limited degree of economic planning that existed during the war were put into practice in the most unfavourable circumstances imaginable, in the absence of any experience and in the form of emergency measures elaborated and executed in great haste. Whatever the merits or demerits of inflation under planned economy may be, the experience gained during the war is entirely unsuitable for use as a basis for forming a judgment on it. It cannot be emphasised sufficiently that inflation during the war was carried out by all Governments in complete

ignorance of what they were doing, and in complete absence of any plans. The haphazard way in which note issue, public debt, and the purchasing power of consumers were increased amounted to a complete leap in the dark. Fortunately for the Governments of the belligerent countries, the public was just as ignorant about the consequences of inflation as the statesmen were themselves, especially during the earlier stages of the war. Otherwise, the destructive effects of inflation would have manifested themselves much earlier.

Was war-time inflation entirely devoid of any constructive results? Orthodox economists would like us to believe so. In reality, a fraction of inflationary expenditure, at any rate, produced decidedly constructive results. It is true that a large part of inflationary expenditure was purely destructive and another large part was in the nature of capital expenditure without any permanent benefit to the countries concerned. The increased facilities for the manufacture of armaments were a liability instead of being an asset after the cessation of hostilities. On the other hand, in every country a certain number of useful industrial plants had been constructed. Also means had been found for the better utilisation of agricultural resources. Roads and railways had been constructed, and, even though primarily they served strategical purposes, many of them were beneficial also from an economic point of view.

(7) A New Financial Conception

Over and above all, it is to the credit of war-time inflation that the rigid orthodoxy of the world's financial conception was broken. Even though the exaggeration of inflation after the war provoked a violent reaction in favour of orthodoxy, the experience of 1914–8 was not forgotten altogether. The fact that it was possible during the war to depart from financial orthodoxy for the sake of national defence paved the way for the school of thought which considers it justifiable to depart from rigid orthodoxy in time of peace in the interest of progress and prosperity of mankind.

Admittedly, this new conception has been driven to the extreme by many radical would-be reformers, who believe that the sole reason why the results of war-time inflation were not satisfactory was that it was undertaken for unproductive purposes. They claim that if and when an unlimited expansion of currency and credit is undertaken for productive purposes, it can do no harm, and its result is bound to be highly beneficial. We do not propose to discuss this question in detail at this

stage, but we shall see later that even a comparatively moderate credit expansion can lead to reckless speculation, and can bring about a disastrous slump, if it is carried out in the absence of adequate economic planning. The destructive nature of war-time inflation was due at least to the same extent to the absence of economic planning as to the fact that it was undertaken for unproductive purposes.

CHAPTER VI

INFLATION AFTER THE WAR

(1) Anticipation of Return to "Normal" Conditions

It was not until about the third year of the war that the world began to realise the profound financial effects of the abnormal expenditure necessitated by the conduct of warfare. Even then, practically everybody regarded the abnormal developments in the sphere of finance as essentially temporary. It was taken for granted that the moment the war was over, normal financial conditions would return; that prices would decline to their pre-war level (which for some reason had come to be regarded as being necessarily the normal level); that exchanges would return to their old parities; and that apart from the larger amount of public debt and the necessity for higher taxation, the financial machinery would resume its normal course interrupted in July 1914. That this was generally believed is shown by the fact that every time there appeared to be prospects for the conclusion of peace, the exchanges tended to recover. The prices of commodities were less sensitive to peace prospects, owing to the persistence of demand and to the limited supplies available. But the fact remains, that when in September 1918, Bulgaria surrendered to the Allies and the defeat of the Central Powers became evident, there was a slump in the prices of certain commodities in Austria-Hungary and Germany. The slump, of course, proved to be short-lived, for it was realised before long that the end of the war did not mean the end of inflation.

In fact, with the cessation of hostilities, inflation was only beginning to produce its full effect. We said in Chapter IV that for various reasons the effects of inflation were not only disguised but also suppressed to some extent during the war. Exchanges were pegged, and prices were controlled. Above all, the public did not adequately realise what was happening, and did not, therefore, anticipate future depreciation. To a very large extent, financially speaking, the world lived in a fool's paradise during the war. While the war lasted, everybody was concerned only with the supreme effort to save the

country from the enemy, irrespective of cost. Although Great Britain, and to a less extent Germany and one or two other belligerent countries, endeavoured to cover at least a fraction of war expenditure by normal taxation, it is correct to say that, generally speaking, the problem of paying for the war was not tackled until after the war.

(2) Huge Public Debt

At the time of the Armistice each one of the belligerent countries was confronted with a huge public debt. A large portion of this public debt assumed the form of international indebtedness, which further complicated the situation. But in every case, the internal debt itself was large enough to confront the statesmen with a financial problem of unprecedented magnitude. How was the immense burden of the public debt to be carried? Everybody agreed that as a result of the heavy loss inflicted upon all belligerent countries by the war, the taxation capacity of the nations was much smaller than in 1913. Indeed, at the time of the Armistice, the effect of the destruction of wealth and human beings upon the taxation capacity of the world was probably over-estimated, and the extent of the capacity of the human race to recover from the disaster was under-estimated. Notwithstanding this, it was considered conceivable at the time that the increased burden would be met by normal means of taxation.

In the case of the neutral countries and of the United States, this appeared fairly reasonable, since the increase of their public debt was accompanied by an increase in the national wealth. As far as the United States and other overseas countries were concerned, there were also, unquestionably, immense possibilities for the expansion of the national wealth. The state of affairs was, however, totally different in Europe. While it would have been unduly pessimistic to maintain that most European countries had already attained the highest degree of their development, possibilities of further expansion of their wealth were relatively limited. There appeared to be little hope that the increase of the national debt would be offset in the course of time by an increase in the national wealth.

(3) An Unconvincing Parallel

The student of history may object to this that at the conclusion of the Napoleonic Wars, the prospects of the world's carrying the burden of the public debt appeared to be just as hopeless as they appeared to be in 1918, and yet most European

countries managed somehow to carry and even increase their public debts during the hundred years that separated Waterloo from the Marne. During the Nineteenth Century there was, however, an unprecedented expansion of industrial activity. Was it reasonable to hope in 1918 that there would be a similar expansion during the Twentieth Century? It is not likely that any of the statesmen who governed the destinies of the European countries in 1918 was sufficiently optimistic to anticipate such favourable developments. Notwithstanding this, none of them had the courage and the vision to decide to face facts and take up a realistic attitude towards the question of public debt.

The British statesmen probably trusted to the loyalty and discipline of the British taxpayer to pay an income tax of between 4*s*. and 5*s*. in the pound for the next ten generations at least. The French statesmen probably hoped to recover a large part of war expenditure out of reparations imposed on Germany. The German statesmen were too crushed by the defeat and by the astronomic figure of reparations to think of elaborating any plans for the future.

In any case, for some years at least after the Armistice, the problem was not how to face the burden of war expenditure, but how to prevent a further increase of public debt, or at any rate, how to keep down this increase as far as possible. None of the late belligerent Governments succeeded in checking the tide of abnormal expenditure immediately after the cessation of hostilities. Demobilisation was a slow process, and many expenditure items continued even after demobilisation. The reconstruction of devastated areas in various countries involved very heavy outlays. In any case, it was extremely difficult to change the spendthrift mentality of Governments and Parliaments accustomed to seeing heavy deficits during the war.

(4) How to Pay for the War

The attitude of the statesmen towards the problem of the public debt was characterised by an utter lack in a sense of realities. Great Britain was not the only country to expect to restore the monetary unit to pre-war parity, and thus to increase considerably the real burden of the debt. There was not one single Government which was able to face the fact that in the long run the increased burden of public debt could not be borne unless it were drastically reduced by a reduction in the value of the monetary unit in which the debts had been contracted.

The word "devaluation" was unknown to the vocabulary of statesmen ruling the world at the time of the Armistice. Having grown up in the pre-war school of finance, they imagined that it would be possible to carry the burden with the aid of taxation and more taxation, in the hope that the burden would gradually be reduced by conversion and redemption. The neutral countries were, of course, entirely justified in pursuing such a policy since their public debt was not excessive. In this respect, the United States may be classed with the neutral countries, since notwithstanding the heavy increase of her indebtedness, her burden was tolerable. Among the European belligerent countries, only Great Britain adopted the same policy. In her case, its adoption was not, however, justified as subsequent events were to prove.

(5) Why Continental Belligerent Countries Inflated

All the continental belligerent countries, victor and vanquished, chose a different method of reducing their public debt inherited from the war. They attained it by a gradual depreciation of their currencies. Their choice was not made deliberately. It was not with the object of reducing the burden of the public debt that they continued to inflate after the war. They were simply unable to stop the process. In the case of France, the necessity of reconstructing the northern and eastern provinces made inflation unavoidable. In the case of Germany, inflation was forced upon the Government by excessive reparation demands. In the case of Austria-Hungary and the various succession states of the Austro-Hungarian and Russian empires, the difficulties of settling down in the new conditions created by the peace treaties forced inflation upon the Governments. In the case of Italy, internal political troubles were responsible for continued inflation.

None of these countries adopted a deliberate policy of reducing their public debt through depreciation of their currencies. It is a great pity that this was so, for, since currencies had to depreciate in any case, it would have been better to bring about their depreciation by a deliberate policy rather than allow things to drift. Had all countries decided upon a drastic devaluation after the end of the war, they would have stood a chance of being able to maintain stability at the new levels. As it was, their currencies were allowed to find their own levels, and in many cases this process assumed an avalanche-like character which could not be checked until it had caused the maximum of damages.

In Germany, Russia, Poland, Austria and Hungary, inflation practically wiped out the monetary unit. It is true that at the same time it also wiped out the public debt, but experience has proved that this method of paying for the war is unsatisfactory in the long run, for it was not only public debt that was wiped out, but every form of capital and savings, which was not invested in real wealth. This destroyed capital had to be restored in order to secure a normal existence to the countries, and it could only be restored through the creation of new indebtedness, which in the case of Germany, Austria and Hungary assumed the form of external debts.

(6) Reducing Debt by Moderate Inflation

It is thus evident that inflation driven to extremes is not a suitable way of solving the problem of excessive indebtedness. On the other hand, relatively moderate inflation goes a long way towards a solution of that problem. By checking inflation before it got out of control, France, Italy, Belgium, Portugal and Czechoslovakia managed to reduce their burden without, at the same time, destroying the capital and resources indispensable for the working of a modern state. In the Baltic states the depreciation of the currency went rather further, but since the capital resources of these countries were in any case moderate, the destruction thus caused was not excessive.

Even though moderate inflation was helpful in reducing the burden of indebtedness, this reduction was largely offset by the circumstances in which the depreciation of currencies took place. In almost every case, the depreciation of the monetary unit was due to inflation in the form of budgetary deficits. Thus while, on the one hand, the real burden of the debt declined through the depreciation of the monetary unit, its nominal amount increased as a result of the deficits. Had the reduction been made by straightforward devaluation instead of gradual depreciation through budgetary deficits, the real burden of the debt could have been reduced to a much larger extent. As it is, practically every country carries an excessive amount of debts inherited from the war, and increased after the war.

CHAPTER VII

THE POST-WAR CHAOS

(1) Optimism followed by Disappointment

The optimism that gave rise to the popular assumption that the end of the war would be followed by an early return to normal financial conditions soon proved to be unjustified. As we have pointed out in the last chapter one of the reasons why it was impossible to resume where the world had left off in 1914 was the existence of a huge public debt in every country. This, in itself, would have made it extremely difficult to balance the budget and to stop inflation immediately after the cessation of hostilities. There were, moreover, many other reasons why it was inevitable that the war should be followed by world-wide financial chaos.

There was, in the first place, the inevitable removal of restrictions upon consumption introduced during the war. While during the emergency the public in various countries was prepared to do without many of their necessities, immediately after the war there was an orgy of consumption of luxuries and other commodities that had had to be dispensed with for more than four years. As soon as normal communication was restored, train-loads of Swiss chocolate were imported to the Succession States, and ship-loads of Brazilian coffee to Central and South-Eastern Europe, without anybody caring much how all these consignments would be paid for. This demand made it possible for the war-time boom to continue in neutral countries, and also in some of the former belligerent countries. Its inevitable result was the increase of the international indebtedness of financially weaker countries.

(2) Unpegging of Exchanges

The first shock which made the world realise that it was only beginning to pay for the war was the unpegging of the Allied exchanges in March 1919. Until then, the financial deterioration caused by the war was largely disguised by the misleading stability of the principal exchanges. Responsibility for the decision to unpeg the exchanges rests largely with the British Government, which was subject to much criticism,

especially from the French side. In fact, this was the first realistic step made by the British Government after the war. It would have been an unpardonable mistake if the British Government had continued to use up its resources and increase its external indebtedness for the sake of bolstering up sterling and other Allied currencies at an unjustifiable level. Such a policy would have merely encouraged reckless spending overseas by impoverished Europe. If a mistake was made in this connection, it was that five months were allowed to elapse after the Armistice before this obvious step was taken.

The inevitable result of the unpegging of Allied exchanges was a heavy fall of sterling and of the other European Allied currencies. The exchanges of the Central Powers had already begun to fall after the Armistice. The Russian rouble was practically wiped out by 1919 by the reckless financial methods that are inevitably associated with Civil War and revolution. A few months after the end of the war, the world was plunged into a currency chaos which surpassed the most pessimistic anticipations.

(3) Inflation had to Continue

It is sometimes suggested that had the Governments of the late belligerent countries taken firm deflationary steps immediately after the war, the post-war chaos would have been averted. In reality, it was impossible to check the trend. As far as Russia and the vanquished Central Powers were concerned, the impossibility of maintaining control over monetary developments was obvious. Revolutions are usually accompanied by inflation. This was the case with the French Revolution, and in Russia history merely repeated itself. The existence of various kinds of currencies issued by the regimes that succeeded each other (Czarist roubles, Kerensky roubles, Soviet roubles and also other roubles issued by the various counter-revolutionary leaders) further complicated the situation in Russia. In Hungary, things were hardly better. The notes issued by the short-lived Hungarian Soviet Government soon depreciated until they became almost unusable for the purchase of commodities. The revolution weakened the executive power also in Germany and in Austria, thereby making it more difficult to resist inflationary pressure. It was politically impossible for any of these Governments to try to reverse the tide by adopting a deflationary monetary policy.

Although conditions in Allied countries were much less unfavourable, even their Governments would not have been in a

position to deflate after the war. Apart altogether from the fact that public expenditure had to remain abnormally large for some time after the Armistice, it would have been politically impossible even for the Governments of the victorious Allies to impose upon their nations the sacrifices and sufferings necessitated by deflation. Let us try to imagine what would have happened if the Armistice had been followed by a sharp deflationary crisis and an increase of unemployment. It was in any case difficult enough to find work for the demobilised soldiers, and the task would have been made entirely impossible by a deflationary slump early in 1919. It is highly probable that wholesale unemployment immediately after the war would have resulted in a revolution in more than one Allied country. In the circumstances, the post-war boom may be said to have fulfilled a historical mission by enabling the late belligerent countries to absorb temporarily at any rate a large part of their demobilised soldiers. It is true that in less than two years after the Armistice the boom was followed by a slump. The breathing space between 1918 and 1920 was, however, invaluable from the point of view of the political consolidation of the late belligerents. It is one thing to resume employment after the war and lose it after a while, and a totally different thing to leave the army only to swell the ranks of the unemployed. The postponement of the slump until 1920 has probably saved several countries from grave internal political disorders.

(4) Difficulties of Disentanglement

Apart from the continuation of inflation and the unpegging of exchanges, the financial chaos was largely due to the disintegration of two important Empires. The establishment of the political independence of various parts of the former Austro-Hungarian Monarchy and of the Russian Empire was a simple matter compared with the task of disentangling the complicated monetary situation which had thus arisen. It is true that soon after the Armistice the monetary situation of Europe became simplified through the withdrawal of currencies issued by the occupation armies of the Central Powers in various countries. At the same time, the newly created states were anxious to establish their own national currencies. Among the Succession States of the Austro-Hungarian monarchy, this process largely assumed the form of stamping the krone notes circulating on the territory of the various succession states at a given moment. This method led to whole-

sale abuses in the form of smuggling krone notes by the million into the country whose currency retained the highest value, and of faking the stamps required for securing their validity. No measures of exchange restriction, however vigorous, were able to prevent this smuggling. In some countries, such as Roumania, Jugoslavia and Poland, various currencies were in circulation concurrently, and the ratio between them was subject to fluctuation. It was several years before these entanglements could be disposed of effectively.

In addition to the material factors which were responsible for the post-war currency chaos, psychological factors also worked in the same direction. In many countries, the Governments, Parliaments and the public had acquired an inflationary mentality. While before the war every additional expenditure item was carefully scrutinised and criticised, after the war little care was taken to check the wave of expenditure. The world became accustomed during the war to think in big figures, and it was not easy to switch back to pre-war mentality in matters of finance.

(5) Rise in Prices Resumed

Throughout 1919 and during the first half of 1920 inflation continued unabated. The comparatively moderate fall in prices that occurred in most countries immediately after the Armistice soon gave way to a rising trend, and the price level in most countries touched new high records during the first half of 1919. Indeed, the rise in prices was much more rapid than during the war. Price fixing was abandoned in most countries, and natural demand was allowed to take its course. It is true that supply also increased simultaneously with the demand for consumption. The increase of supplies was, however, a gradual process. It was some time before it became possible to convert factories from manufacturing armaments and other requirements of the national defence to providing for the requirements of the civilian population. In some countries, part of the means of production was destroyed during the war, and the efficiency of the remainder was generally reduced to a low level. Means of transport were also lacking, owing to the disorganisation of the railway systems and the heavy loss of shipping tonnage during the war.

In the course of 1919, supplies were beginning to arrive, however, with increasing facility. As we said earlier in this chapter, it was only too easy to import commodities after the war and the temptation of overspending was too great.

If, in spite of the increasing supplies, prices were rising rapidly, this was due in part to the fact that during the war they were kept artificially low, and in part to the urgent and impatient demand for all the commodities of which there was a shortage during the war. It took the public some time to realise that the shortage in raw material, foodstuffs and even manufactures was essentially a phenomenon due to the war.

Throughout 1919, producers, merchants and consumers alike endeavoured to increase their supplies as a result of this prolonged war mentality. Their insistent demand drove commodity prices up in spite of the increase of supplies. In Great Britain the index number of wholesale prices rose to the high record of 310 in 1920. In the United States, the maximum level of 270 was reached. In some of the neutral countries the rise was still more considerable. With the removal of the main obstacles to international commercial and financial intercourse, the rising trend had become world-wide, and had spread all over Latin America and the Far East. The rise was, needless to say, the most rapid in countries of Central Europe, not to speak of Russia where the complete breakdown of production and the non-stop working of the Printing Press was driving prices to fantastic levels.

(6) Deferred Use of Purchasing Power

During the war, inflation was due to the creation of additional purchasing power as a result of abnormally large war expenditure. After the war, the creation of artificial purchasing power continued for a while, though not to the same extent as during the war. It was not the primary cause of the accentuation in the rise of commodity prices. Post-war inflation can be partly explained by the deferred employment of purchasing power created during the war when, as we said in earlier chapters, the absence of adequate supplies and rationing prevented consumers from using their increased purchasing power to the full extent. The increase in the note issue also continued during the first post-war year, but to a large extent this was the effect rather than the cause of the rapid rise in prices. While in the countries of Central Europe and in Russia the Printing Press became the sole source from which Government deficits could be met, the leading Allied countries were from 1919 onwards well in a position to cover their deficits with the aid of normal borrowing. If, in spite of that, the note circulation continued to rise, it was because of the increased requirements for currency caused by higher prices.

(7) Bank Credit Expansion

There was, at the same time, an expansion in the volume of ordinary banking credit. During the war, the large Government disbursements obviated the necessity for many producers and merchants to avail themselves of bank credits to anything like the extent that they had before the war. In most countries, the volume of bank credit actually declined between 1914 and 1918. Owing to the profits made through the rise in commodity prices and through highly lucrative deliveries of goods for war requirements, a large portion of pre-war debts to banks was liquidated. After the war, on the other hand, the feverish business activity, coupled with increasing taxation on war profits, made it necessary for merchants, manufacturers, etc., to avail themselves of bank credits once more.

Many economists believe that it was this expansion of bank credits, together with the increase in the note circulation, that produced an inflationary effect and caused commodity prices to rise. Those who maintain this view seem to confuse cause with effect. As we explained above, the rise in prices was due to the urgent demand after the war. Had the banks been less generous in granting credits to their customers for the purpose of producing or importing goods, the demand would have existed none the less, and the commodity supplies to meet the demand would have been lower. The chances are, therefore, that the rise in prices would have been even more pronounced. Admittedly, a deliberate policy of credit restrictions immediately after the war would soon have checked the rising tendency, as indeed the application of such a policy actually did during the second half of 1920. But, as we have pointed out above, for political reasons alone it would have been impossible for the Governments of the late belligerent countries to adopt a deflationary policy immediately after the war. In submitting to inflationary tendencies without resistance they decidedly chose the smaller of the two evils; for in reality, the choice was not between inflation and deflation, but between inflation through the working of economic factors, and inflation as a result of internal political troubles which deflationary attempts would have brought about. The choice of the first alternative was not in any way the result of supreme wisdom on the part of the post-war statesmen. It is highly probable that they did not realise that their countries were heading towards inflation that was to overshadow anything

experienced during the war. As is very often the case, the world tumbled upon the right solution by mistake and ignorance.

As soon as the statesmen realised the nature and extent of post-war inflation, they took steps to check it. It is fortunate that they did not consider it necessary to take the deflationary steps eighteen months earlier. We shall see in the next chapter that the deflationary policy adopted in 1920 was a fatal mistake for which the world is still paying the price. The consequences of the mistake would have been even more fatal had it been committed earlier.

(8) Political and Economic Effects

It is often stated that post-war inflation was responsible for internal political troubles in Central Europe after the war, and that by wiping out the German middle classes, it prepared the ground for the National Socialist victory many years later. This view may be accepted as correct. This is not, however, in contradiction to the view we expressed above that inflation in many countries prevented internal political troubles. It is all a question of degree. In countries where during the post-war boom the currency depreciated to about one-third of its pre-war value, and this depreciation was accompanied by feverish business activity, inflation played a decidedly useful part. In other countries where the rise in prices was enormous, and the currency was practically wiped out, and where the disorganised state of the economic system prevented the rise in prices from being accompanied by real business prosperity, inflation had a distinctly destructive political effect.

From an economic point of view, post-war inflation, in countries where it remained relatively moderate, was of a distinctly more constructive character than war inflation. In the first place, it financed the conversion of war industries to meet peace-time requirements. It gave a chance to a number of people ruined during the war to make a fresh start. It facilitated the filling of many gaps in the national wealth caused by losses inflicted upon it during the war. If post-war inflation subsequently proved to be of an essentially destructive character in some countries, it is due to two reasons. The one was that it was entirely uncontrolled, much more so even than war-time inflation. The other was that it was followed by one of the most reckless and destructive deflationary movements of financial history. About this, however, more will be said in the following chapter.

CHAPTER VIII

THE POST-WAR SLUMP

(1) A Short-Sighted Policy

According to a favourite argument of its opponents, inflation, even though it may lead to temporary and fictitious prosperity, inevitably ends in deflationary depreciation. While some anti-inflationists put forward this argument from a purely practical point of view, others lay stress on the moral aspects of the inevitable punishment that follows any offence against the canons of sound finance. They point out triumphantly that the reckless inflation that followed the war met its well-deserved punishment in the form of the post-war slump. They regard the sufferings inflicted upon mankind between 1920 and 1923 in the same light as the Old Testament regards the punishment of Egypt or Babylon for their sins.

In reality, the post-war slump was inflicted upon mankind by essentially human hands. It was the result of a short-sighted policy which ought to be regarded as the source of most of our economic troubles ever since. The troubles that arose from reparations, war debts, excessive international indebtedness, can all be traced back to the mistaken monetary policy of 1920. It was responsible for the world economic crisis of 1929–34. And it is to be feared that we shall have to continue to pay the price for the short-sighted policy of 1920 for many years to come.

Those responsible for the monetary policy of the leading countries after the war are often accused of having neglected to raise the bank rate and restrict credit early in 1919. It is stated that had they nipped post-war inflation in the bud, the rise in prices would not have been nearly so pronounced, and consequently the fall in prices that followed it would also have been more moderate. We pointed out in the last chapter that it would have been politically inexpedient, even if it had been financially and economically possible, to begin deflation immediately after the war. But even if it had been possible, it would have been a short-sighted policy. Owing to the increase in the burden of public debt, it was

of the foremost importance that the commodity value of the monetary units should be reduced to a sufficient extent to make the burden of indebtedness bearable. The rapidly rising trend of commodity prices in 1919 and 1920 ought to have been acclaimed as the solution which, however unpleasant, had become inevitable by the fact of the war. If the post-war statesmen had not the courage and imagination to solve the problem by a deliberate act of drastic devaluation, the least that might have been expected of them was not to prevent the solution from coming about automatically.

(2) Attempt to Return to 1914

It is the conception that there was something sacrosanct about the original mint parities of the currencies, and even about the pre-war price level, that is the root of all trouble. Much more fundamental laws having been violated without hesitation during the war through the necessity of national defence, the post-war statesmen considered it their foremost duty to devote themselves to the task of restoring the 1914 value of currencies. It is to that conception that progress and prosperity had to be sacrificed. Few people were far-sighted enough to realise that the changes brought about in the financial situation of the world as a result of the war would amply justify a drastic scaling down of the monetary unit. Apart altogether from practical considerations, even from a purely moral point of view, it would have been the right thing that the generation responsible for the war should do its utmost to bear the burden of liquidating its financial consequences, instead of crippling future generations by leaving to them this negative legacy.

(3) Fictitious Wealth *v.* Real Wealth

The rapid rise in prices after the war was the natural consequence of the huge financial sacrifices made during the war. As a result of the unprecedented expenditure between 1914 and 1918, the fictitious wealth, represented by public debt and various other forms of capital without intrinsic value, rose to a multiple of its pre-war figure. At the same time real wealth, represented by all possessions of a tangible value, declined considerably, as a result of the destruction and deterioration caused by the war. It is necessary that there should be some kind of ratio between the volume of fictitious wealth and that of real wealth. By ratio, we do not mean a

fixed figure, but a reasonably wide range within which the figure can fluctuate without causing grave disturbances.

The existence of fictitious capital is a necessity for the development of the modern economic system. Its absence in backward countries is largely responsible for the difficulties of converting natural resources into socially useful wealth. Progress and prosperity require a certain minimum amount of fictitious capital, without which even the most highly developed industrial system becomes paralysed. On the other hand, if the fictitious capital exceeds the proportions required, it may become a dead-weight burden which will handicap progress and interfere with prosperity. This is all the more so because fictitious capital has to be fed at the expense of income derived from production. If an unduly large proportion of this income is earmarked for the dividends on fictitious capital, the producer's share in the receipts of his work becomes reduced to an inadequate figure. Although to some extent fictitious wealth serves as a basis for credit for production, to a large extent it tends to become unproductive and serves the purpose of enabling the rentier classes to live on the earnings of the productive classes. To a certain extent the existence of rentier classes is necessary to serve as an inducement for work in the hope of enjoying its fruits later in peace and security. But there must be a limit beyond which the productive classes cannot keep the unproductive classes. If too large a proportion of the earnings of producers is earmarked for feeding the fictitious capital, it is bound to handicap production.

(4) An Excess of Paper Wealth

Before the war, the ratio between real wealth and fictitious wealth was more or less normal in Central, Northern and Western Europe. It was below normal in Eastern Europe, the United States and the British Dominions, and it was considerably below the normal in the rest of the world. Had fictitious capital increased merely in these relatively undeveloped countries, the change would have been for the better. In reality, fictitious wealth increased in the relatively undeveloped countries to the least extent, and in Europe to by far the largest extent. As the proportion of fictitious capital was already sufficiently high in most parts of Europe, this increase resulted in an excess of paper wealth.

There are three ways in which the disequilibrium between fictitious wealth and real wealth can correct itself. The first is through a corresponding increase in the production of real

wealth. This is undoubtedly the most desirable way of restoring equilibrium. Had war-time expenditure pursued constructive purposes, to a large extent the increase of fictitious wealth would have been offset by an increase of real wealth. Even then, as we pointed out in an earlier chapter, in all probability the absence of economic planning would have led to over-production and waste. As it was, the counterpart of the fictitious wealth created during the war consisted of war material of no social utility. Nor was there any hope of restoring equilibrium through an increase of production after the war. Under the system of liberal capitalism, the production of real wealth stood no chance of catching up the increase in fictitious wealth. For every substantial expansion of production is bound to lead, in the absence of planning, to disequilibria and relapse such as we witnessed after 1929.

Another way of restoring equilibrium between fictitious wealth and real wealth would have been through a drastic levy on capital immediately after the war. This solution was attempted in some countries, but its result was nowhere very encouraging. Possibly in Great Britain, with its highly organised system of direct taxation, it might have stood a better chance of succeeding. However that may be, as it was not done immediately after the war, there was no possibility of doing it later when war profits were largely offset by the slump, high taxation and prolonged depression.

The third solution of the problem would have been the scaling down of public debts to bearable proportions by default. For obvious reasons, this solution could not be considered by any of the countries which valued their financial reputation. For even though the depreciation of a currency through monetary inflation is also an act of default, especially if it is followed by devaluation, it is considered in a totally different light from a deliberate breach of contract by the debtor. From the point of view of the holders of Government loans, the reduction of their value through the depreciation of the currency is not nearly as painful a process as the reduction of their value through partial default.

(5) Correcting the Excess

Obviously, the right way to correct the excess would have been to reduce the fictitious capital by lowering the value of the monetary unit in which this fictitious capital is expressed. The principle involved is a matter of simple arithmetic. Every-

body possessing paper wealth in the form of Government bonds or mortgages, bonds, shares, etc., possesses a claim on the real wealth of mankind. If the total of these claims becomes ten times higher than it was before the war while the real wealth on which the claim is made declines in volume it is arithmetically impossible that a certain unit of the fictitious wealth should still represent a claim on exactly the same volume of real wealth. If an attempt is made to maintain the unit of fictitious wealth at the same level as it was before, disequilibrium is bound to arise. In given circumstances disequilibrium may become absolutely intolerable, and in that case, it reduces itself *ad absurdum* before long. That would have been the case if, by some means, France, with her public debt of three hundred milliard francs, had succeeded in restoring the pre-war value of the franc. In that case, the public debt of France would have exceeded considerably the national wealth. The situation would soon have become untenable, and would have found its natural corrective in the form of a depreciation of the franc.

In the case of Great Britain, the change in the proportion of fictitious wealth to real wealth was not quite sufficiently marked to create an absolutely intolerable state of affairs. There was grave disequilibrium but the burden imposed upon production was not absolutely unbearable, especially while the commodity value of the monetary unit remained below its pre-war figure. The change in the proportion, absurd as it was, failed to reduce itself *ad absurdum* for some time. Nevertheless, it was sufficiently marked to make the undesirability of restoring the monetary unit to its pre-war value obvious.

When, during 1920, the price level in Great Britain was rising to above threefold the pre-war figure, accompanied by similar rises all over the world, it was a natural and normal process of readjustment. Since the statesmen failed to realise the necessity of deliberately bringing about such readjustment, it was natural that the disequilibrium between real wealth and paper wealth should tend to produce its own corrective. It is true that the immediate cause of inflation after the war was not necessarily the excessive amount of fictitious wealth, but in this world, as often as not, the right thing happens for the wrong reason. The rise in prices during 1920 was decidedly a desirable process of readjustment. Painful as it was, it was made necessary by the financial developments during the war.

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(6) Rise in Prices Reversed

Lack of foresight and inadequate financial statesmanship caused, in 1920, the check and reversal of this process of readjustment. Instead of waiting until the depreciation of the monetary units had attained a sufficient degree to eliminate the disequilibrium caused by the increase of fictitious capital, and then devaluing the currencies at that level, the Governments and Central Banks of the countries concerned took deliberate action to prevent the readjustment from taking place.

The rise in prices reached its peak in most leading countries in the spring of 1920, but in some countries it went on until the autumn. Already, in 1919, some Central Banks were beginning to take steps to check the rise. The bank rates were gradually raised until in the spring of 1920 they stood, both in Great Britain and in the United States, at the panic level of 7 per cent. At the same time, ruthless measures of credit restriction were put into operation everywhere. As a result, holders of stocks were forced to throw their commodities upon the market, and this broke the boom. A slump, once started, is like an avalanche which cannot be checked until it has spent all its destructive force. The more prices fell, the more holders of stocks were compelled to liquidate in haste. The slump soon assumed a world-wide character. Even in Germany and in other countries where the budgetary situation tended to create inflationary rather than deflationary conditions, there was a heavy fall in commodity prices during 1920 and 1921. In countries as remote as Japan, the price level fell by about one-third.

(7) Effect of the Slump

The inevitable result of the slump was a world-wide increase in unemployment. It wiped out one of the very few favourable effects of the war, namely, the reduction of private indebtedness. As a result of the depreciation of the monetary unit and of profits made during the war, the burden of private debtors had become considerably reduced between 1914 and 1918. This reduction offset to some extent the increase of fictitious wealth through the increase of public debts. It provided a fair scope for the contraction of new debts for productive purposes. Since the post-war boom was financed largely by means of borrowing, the result was that private indebtedness had once more increased considerably by 1920.

With the appreciation of the monetary unit through the slump of 1920 and 1921, the burden of this newly contracted debt became in innumerable cases excessive. It led to the ruin of many enterprises and it created large amounts of frozen credits all over the world. The post-war slump weakened the banking position in many countries. In Great Britain, among others, the banks had become tied up in frozen Lancashire and other credits, and this was the main reason why during subsequent years they were unable to play a sufficiently active part in financing trade.

By the middle of 1921 the slump was over in most countries, but in a number of important countries, such as the United States, Great Britain and Japan, etc., it provided the initial stage for a slow process of deflation, which went on incessantly until it culminated in the world crisis. Temporary and insignificant rallies apart, the world price level declined incessantly from about March 1920 till about March 1933. The disastrous policy of 1920 bore its fruits for more than a decade. A tendency towards restoring normal ratio between fictitious wealth and real wealth was reversed, and disequilibrium has increased ever since.

(8) Inflationary and Deflationary Group of Countries

Until 1921, monetary developments all over the world followed a more or less identical course. Between July 1914 and November 1918 there was an inflation of a gradually increasing degree. For a few months after the Armistice there was a moderate but really world-wide fall in commodity prices, but early in 1919 inflation resumed its course everywhere and went on until 1920, when it was followed by a world-wide slump. There were, of course, considerable differences in the degree of the upward and downward movements in various countries, but the tendencies were more or less identical. From 1921 onwards, however, the world became divided from a monetary point of view into two groups of countries. One of them included the United States, Great Britain and the British Dominions, Japan, the former neutral countries and Czechoslovakia. These countries made use of the turn in the tendency of prices to regain control over their currencies by deflationary means. Between 1922 and 1926 they all stabilised their currencies after a period of deflation. As in this part of the book we are concerned with the history of post-war inflation, we propose to follow the fate of this group of countries in Parts II and III dealing with stabilisation and deflation.

The second group of countries included practically all the former continental belligerent countries, with the exception of Czechoslovakia. In these countries inflation was resumed as soon as the slump of 1920–1 was over. We propose to deal with their fate in the next chapter.

CHAPTER IX

INFLATION RESUMED

(1) The Slump—an Interval in Inflation

For the former continental belligerent countries, the slump of 1920–1 provided only an interval in the course of their post-war inflation. Indeed, strictly speaking, the inflationary factors never for a moment ceased to exist in most of these countries. Their budgets remained unbalanced, and artificial purchasing power continued to be created all the time. If, in spite of this, they experienced a slump in 1920, it was due to several reasons. In the first place, the inflation of 1919–20 was beginning to proceed rather too fast, and anticipated to some degree a future expansion of purchasing power. This being the case, commodities at their top level in 1920 became vulnerable, and any technical measures of restriction, however inadequate compared with the extent of inflation, were bound to produce the maximum of effect. This was the reason why the raising of the bank rate and credit restrictions not only in the United States, Great Britain and Japan, but even in France, Germany and other countries, produced such a spectacular effect.

Apart from this, for psychological reasons, the effect of the price movements in one country upon those of another country were at the time considerable. The public did not adequately realise that the differences in the monetary situation in various countries justified differences in the tendency of their prices. As the price levels moved more or less together until 1920, it was taken for granted that they would continue to move together. As a result of this assumption, the fall in prices in the United States, Great Britain and Japan provoked corresponding tendencies in other countries whose monetary situation would not in itself have justified a slump. Thus, both the technical and the psychological factors favoured a sympathetic downward movement of prices even in countries which continued to inflate.

(2) Three Degrees of Inflation

Once the downward movement attained a certain stage, these factors were, however, no longer able to offset the influence of inflation. The slump came to a standstill, and after some hesitation, prices began to rise again. Thus, in 1921, the ways of the deflationary group of countries and those of the inflationary group of countries parted. Even within the group of inflationary countries, the existence of a sub-division soon manifested itself. The group consisted, in reality, of three groups divided from each other according to the degree of inflation.

There was the extreme inflationary group including the Central Powers, with the exception of Bulgaria and Turkey, and also Russia and Poland. In these countries, inflation was entirely out of control by 1921. A second group consisted of the Balkan states and the Baltic states where inflation attained a high degree, but where the Governments did not altogether lose control. There was a third group consisting of the Latin countries, France, Italy, Belgium, Spain, Portugal and Latin America, where inflation remained within relatively moderate limits.

(3) Inflation in Germany

Germany is usually quoted as the typical example of destructive inflation. Her example is frequently used and abused as a warning. Whenever and wherever it is suggested that the authorities should depart, however slightly, from the rigid principles of extreme orthodoxy, the retort is always a warning that the country concerned will be driven into the abyss of inflation, and will share the fate of Germany. Indeed, her example is not one to be followed. The whole of the savings of the nation, unless they were invested in real goods, was wiped out in 1923. The working capital indispensable for the highly developed system of the country was totally destroyed. The middle classes were completely ruined, and extreme inflation inflicted upon the German nation a degree of suffering unprecedented in modern times. Although, it is true, inflation wiped out public and private indebtedness, the destruction of capital was so complete that it became necessary for the nation to borrow heavily abroad. There is indeed no argument possible in defence of such a degree of inflation, which had absolutely no redeeming features or mitigating circumstances to offset the immense harm it had done. It was beyond doubt an unqualified evil.

Orthodox economists do not fail to make full use of the profound impression left by German inflation on the minds of the generation that witnessed the disaster. They maintain that such an extreme degree of inflation is the logical outcome of any departure from the canons of sound finance. They argue that once the first step is taken in that direction, it is impossible to stop, and disaster is inevitable. This argument is contradicted by the whole history of post-war finance, which contains many examples of countries which succeeded in checking inflation before it produced disasters comparable with Germany's experience.

(4) Why Germany Inflated

But to be able to dispose more effectively of the popular orthodox sophistries, it is necessary to examine the circumstances in which inflation in Germany attained an extreme degree. Defeat and revolution undermined the power and prestige of the German executive power to no slight degree. To check the inflationary tendency initiated during the war would have required a very strong executive, the absence of which in itself was sufficient to make it extremely difficult to keep inflation under control. Germany became, moreover, economically more exhausted during the war than any other country. Her commodity stocks were utterly depleted, and the nation was in a starving condition. In the circumstances, the replenishment of the most indispensable food and raw material supplies was bound to weaken the technical monetary position to no slight degree.

Above all, there was the crushing burden of reparations. We shall deal with its general aspects, together with those of war debts, in a later chapter. At the present stage we shall confine ourselves to indicating the inevitable effect of the huge reparations demands of the Allies upon the German currency. Had there been no other adverse factors in operation, this factor alone would have been amply sufficient to force Germany into extreme inflation. Internally, the necessity of making heavy reparations payments in cash and in kind brought about an increase of the budgetary deficit to a figure at which restoration of equilibrium was out of the question. Thus, Germany was compelled to inflate on a large scale to satisfy Allied demands for reparations. In addition, the transfer of reparations in itself would have been sufficient to reduce the value of the mark to an insignificant fraction. Most people in Germany duly realised that owing to the excessive reparations

demands of the Allies, the mark was doomed. There was, consequently, a flight of capital from Germany which accentuated and accelerated the inevitable process of depreciation.

(5) Was Inflation Deliberate?

There was also the political effect of excessive reparations demands. It is often suggested that the German Government deliberately depreciated the mark so as to prove its incapacity to pay the reparations imposed upon Germany by the treaties. It is possible that the German Governments had such consideration vaguely in mind and that consequently they did not exert themselves to the utmost to fight the inflationary trend. But even if they had put up a most desperate fight against inflation, it would not have made any difference to the outcome. The final collapse of the mark might have been postponed for some months, but the result would have been exactly the same.

During the comparatively early stages of inflation, there were in fact some attempts on the part of the Government to keep the movement within comparatively moderate limits. After the Ruhr occupation, however, the German Government and nation was seized with despair and the monetary policy was characterised by a feeling of complete demoralisation. It is, in fact, possible that at that stage the advent of the collapse was deliberately accelerated by reckless expenditure in connection with the passive resistance in the Ruhr.

These were the circumstances in which inflation attained extreme stages in Germany. There was the currency already weakened by inflation during the war; there was the exhausted state of the country; there was the defeat and revolution which reduced the capacity of the executive power to keep monetary developments under control; there was the necessity of replenishing food and raw material supplies by weakening the technical defences of the currency; there was the necessity of making huge reparation payments with their effect upon the budget and exchange; there was the wholesale flight of capital from Germany; and lastly, there was the political and financial effect of the Ruhr occupation. Is it conceivable, we may well ask, that the effects of such a formidable series of adverse factors should repeat themselves in circumstances totally different from those prevailing in Germany during 1918–23? To the minds of all but the fanatic deflationists, the answer must be emphatically in the

negative. And yet time after time we are told that if France were to devalue the franc to the extent of 20 per cent, or if the British Government were to continue its policy of cheap money, or if President Roosevelt were to spend a few milliards on public works, France, Great Britain and the United States would share the fate of post-war Germany. The argument could be regarded as childish, if it were not so thoroughly dishonest.

In order that either France or Great Britain or the United States should be reduced to the state of extreme inflation witnessed in Germany in 1923, it would be necessary for them first to lose a prolonged and desperate war, then to be subject to a revolution, then to be landed with a reparations indebtedness twenty times their maximum capacity to pay, then to be subject to enemy occupation, etc. etc. If they ever have the misfortune of going through such an experience or some experience equivalent in the extent of suffering, then and only then they may become the victims of extreme inflation. Ruling out these possibilities as extremely unlikely, the warning that if these countries depart from rigid orthodoxy they might share the fate of post-war Germany is nothing but cheap demagogy, the bad faith of which is only too obvious.

(6) Inflation in Russia

The only country whose currency shared the fate of the mark was Russia. There again, conditions were entirely exceptional. The war weakened the monetary position of Russia to a larger extent than that of any other Allied country. The first revolution destroyed the authority of the executive and unchained all the influences which inevitably lead to inflation under an unstable political regime. The second revolution placed a regime in power whose declared policy was to reduce *ad absurdum* the monetary system inherited from capitalistic society. From the point of view of results, it is immaterial whether or not this policy was merely an attempt to create a theoretical justification for the inevitable monetary disaster that was to take place in any case. Even if the Soviet Government had been inspired by strictly orthodox monetary principles, it would have been unable to prevent the slump of the rouble. In Russia, civil war continued for years after the cessation of hostilities in other parts of Europe. The necessity of defending the country against the invasion by White Russian forces supported by foreign powers would in itself have made the balancing of the budget impossible.

There was, moreover, a complete political uncertainty, which discredited the currency issued by the Soviet Government. It was generally assumed that should the White Russians succeed in regaining control they would repudiate the notes issued under Soviet regime. For this reason, the Czarist roubles commanded a huge premium against both Kerensky roubles and especially Soviet roubles. The complete breakdown of the system of production was yet another reason why the rouble was doomed. It took some ten years for the industrial system to settle down to a reasonable degree of efficiency after the conversion from a capitalist to a communist system of production. During the first few years, industrial production was practically at a standstill. The peasants refused to part with their products since they were unable to buy manufactures. The notes issued by the Soviet Government were, therefore, practically useless for the purchase of commodities. In the circumstances, it was not surprising that they eventually lost their value altogether.

(7) Inflation in Poland, Austria and Hungary

In Poland, Austria and Hungary the depreciation of the currency did not reach quite the same stage as in Germany and Russia. In the eleventh hour it was possible to save at least an insignificant fraction of the value of money. The reason why the Polish rouble shared the fate of the currencies of defeated countries, was partly the extreme difficulty of reorganising the country—which during the war was the scene of much fighting, and was subject to enemy occupation—and partly the war against the Soviet, and the persistence of the danger of Soviet invasion. The newly constructed Poland started her existence entirely without an experienced civil service and experienced Government. She had to learn through trial and error, and her internal troubles, together with the external danger, proved too much for the resisting capacity of the currency.

In Austria the stability of the currency was first undermined by the internal upheaval that followed the defeat. Excessive expenditure under Socialist pressure provided another cause for the rapid depreciation of the krone. There was, above all, the impossible economic situation created by the Treaty of St. Germains. Within her new frontiers, Austria was evidently not economically self-sufficient. Her reduced population consisted largely of unproductive classes, and the productive section was unable to provide for the needs of the

whole population. Her trade balance was inevitably strongly adverse, and an export of bank notes paid for part of the indispensable imports. As for Hungary, she went through political troubles similar to those of Russia. Even after the Soviet regime was replaced by a Conservative Government, the country was at a grave disadvantage under the necessity of feeding a large unproductive refugee population from the territories transferred to Jugoslavia, Roumania and Czechoslovakia, and to the difficulty of exporting owing to the extreme economic nationalism of the neighbouring states.

(8) Why Depreciation was Delayed

What is astonishing, is not that these Central European currencies depreciated as they did, but that they did not depreciate more rapidly and that they did not attain the extreme stage of depreciation much sooner. The reason why they were able to hold out for four or five years was that there was still a large number of people all over the world obsessed by the idea that currencies were bound to return eventually to their pre-war level. This idea was particularly prevalent in the case of the German mark. Owing to the circumstances enumerated above, it ought to have been evident to every reasonable human being that the mark was doomed beyond hope from the very outset. And yet there were many thousands of people in every country who were prepared to buy mark notes when the exchange rate was a thousand, a hundred thousand, or ten millions to the pound, in the hope of making a fortune when the mark exchange returned to 20 to the pound. Those who had such hopes included otherwise quite intelligent people, among them bankers and financial journalists, who were well in a position to know better. They yielded, however, to the temptation of speculating on a rise of the mark because they were hypnotised by the idea that all this depreciation was a temporary state of affairs, and because they trusted to the inherent qualities and wealth of the German nation to recover sooner or later, and to restore the pre-war value of their currencies.

In the light of subsequent developments, these hopes may appear absurd and ridiculous, yet they are not much more so than the assumption that with fictitious wealth at ten times its pre-war total the world could carry on in the long run with the monetary unit restored to its pre-war value. The difference between those credulous souls who bought mark notes in order to become millionaires in sterling one day, and

those naive beings who think that the monetary unit could be restored to its pre-war level notwithstanding the tremendous increase of the proportion of fictitious wealth to real wealth, is really merely one of degree.

Without attempting to minimise the disastrous consequences of extreme inflation, we think it is an omission to overlook altogether the credit side of the balance sheet. Insignificant as it is, it is worth mentioning. It is beyond doubt that during the earlier stages of inflation much constructive work was accomplished in Germany and other countries which would otherwise have remained undone. Those who realised that the mark or the krone was fated to depreciate to a fraction of its original value, hastened to invest their capital in bricks and mortar. Industrialists reconstructed and modernised their factories, bankers built new and spacious premises, farmers improved their property. On the strict rules of orthodoxy, such capital investment was entirely unjustified in the bankrupt state of Central Europe, and but for the departure from these rules, nothing would have been built in that part of the world during the post-war years.

Whatever happened to fictitious capital in those countries, the real wealth created as a result of post-war inflation during its earlier stages remains part of the national wealth. Highly efficient factories in Western Germany, the magnificent bank buildings and municipal dwellings in Vienna—to mention only these—are indisputable proofs that amidst all the destruction caused by extreme inflation, there was also some constructive work done. Admittedly, their value represented a mere fraction of the destruction caused by extreme inflation. But it is probable that long after the wounds caused by the destruction have been healed and forgotten, some of these additions to national wealth will continue to benefit mankind.

CHAPTER X

LIMITED INFLATION

(1) The Example of France

In the last chapter we dealt with the examples of extreme inflation provided by post-war financial history. When orthodox economists talk about inflation, they take good care to quote exclusively these examples. As their object is to discourage any departure from the rigid rules of orthodoxy, it is only natural that they should quote only the very worst cases so as to produce the maximum of deterrent effect. Post-war history provided, however, other examples also, which should, to a large extent, modify popular opinion on inflation. It is not as if these examples would serve to make inflation appear desirable. Far from it. But they provide evidence that inflation, if checked before attaining extreme dimensions, need not be destructive, and that in some cases its advantages more than outweigh its disadvantages.

The country which benefited on balance by inflation after the war was France. She inherited a huge public debt from the war, and, in addition, a national liability represented by the devastated areas. As in other countries so in France Government and public opinion were convinced that in spite of this, the franc would have to be restored to its pre-war value. When prices were taking their natural course during 1919–20, the French authorities, after some hesitation, followed the example of the Anglo-Saxon countries and raised the bank rate in April 1920 to 6 per cent. Credit restrictions were applied, and there was a slump in commodity prices in sympathy with the tendency of world prices. Between April and December 1920 wholesale prices in France dropped by some 25 per cent. Before long, however, commodities resumed their upward course, partly because of the budgetary deficit, and partly owing to the depreciation of the franc caused by speculation and by a flight of capital. The huge expenditure necessitated by the reconstruction of devastated areas maintained inflationary conditions all the time between 1919 and 1926. The Government's share in the expenditure increased

the budgetary deficit to a fantastic figure. The demand for goods in connection with the work tended to raise commodity prices.

(2) Flight from the Franc

This, in itself, would have been sufficient to frustrate any attempt to stabilise the franc at a high level. There was, in addition, the pressure of the exchange. The franc maintained a comparatively high exchange value until 1922 owing to the anticipation of big reparations payments by Germany. As and when hopes of the receipt of such payments vanished, the franc depreciated. Attempts to balance the budget with the aid of direct taxation resulted in the wholesale flight of French capital to escape income tax. When the weak trend of the franc became evident, the effects of this flight from taxation became accentuated by a flight from the franc. Speculators all over the world took advantage of the situation, and a world-wide campaign developed against the franc. This campaign reached its culminating point during the Ruhr occupation. It soon became evident that France was unable to recover even the cost of the occupation, and this, together with the political effects of the adventure, tended to depress the franc further.

In March 1924, M. Poincaré succeeded in bringing about a sharp recovery of the franc with the aid of Anglo-American credits, but the recovery proved to be short-lived. As M. Poincaré tackled only the outward symptoms without trying to remedy the fundamental cause of the depreciation, the result of his intervention could not be of a lasting nature. In any case, taking a long view, it was useless to interfere with the natural trend of the currency towards a level at which the increased burden of public debt became bearable.

(3) Constructive Inflation

The only way in which France could possibly have avoided resuming inflation after the slump would have been to suspend the reconstruction of the devastated areas, pending the receipt of reparation payments from Germany. Had this policy been adopted it might have been possible to stabilise the franc at a high level, but a large part of Northern France would still be in ruins. It is thanks to inflationary financial methods that it was possible to wipe out the traces of destruction. Thus, even though the franc eventually depreciated to one-fifth of its pre-war value, the real wealth of the nation was at the same

time restored to its pre-war level. In fact, owing to the extravagant generosity with which indemnities for the inhabitants of the Northern and Eastern districts were fixed, the value of properties in these districts is now higher than it was before the war.

Admittedly, the French nation had a harassing time between 1922 and 1926, owing to fears that it might be impossible to check the depreciation of the franc, and its wide fluctuations created uncertain conditions. It is equally true that the devaluation of the franc to one-fifth of its pre-war value inflicted heavy losses upon large sections of the population. In spite of this, it is beyond doubt that France has benefited on balance by inflation. Thanks to it, she was able to reconstruct her devastated areas and to rationalise her industries. While in countries where inflation attained extreme degrees it wiped out the working capital of industrial and business houses, in France the relatively moderate degree of inflation enabled these houses to accumulate substantial reserves. It is thanks to these reserves that France was able to resist the world-wide depression for two years, and that even in later stages the effect of the crisis on French trade was relatively moderate.

Above all, the depreciation of the franc reduced the burden of the public debt. When the reconstruction of the devastated areas was complete, France had a public debt of some three hundred milliard francs, which on the basis of the pre-war parity of the franc would have been equivalent to twelve milliard pounds. No country could possibly have carried such an immense burden. Even with the franc depreciated to one-fifth of its pre-war value, the French Government finds it increasingly difficult to raise the huge amounts required for the service of the debt. Any attempt to carry the burden on the basis of the pre-war value of the franc would have produced disastrous effects, and would have reduced itself *ad absurdum*.

In pointing out that on balance France benefited to a large extent by the comparatively moderate inflation she experienced, it is not our intention to suggest that it is desirable deliberately to follow her example. The devaluation of a currency to one-fifth of its original value is a measure which no country would deliberately resort to except in cases of extreme emergency. It is well to bear in mind, however, that if circumstances are such as to make a devaluation similar to that of the franc unavoidable, it should not be regarded as something like a national calamity. Provided that the policy

of depreciation is pursued skilfully, the nation may, in fact, benefit by it to a large extent. It is not suggested that any nation should ever undertake it for the sake of this benefit. On the other hand, it is important to realise that it is not worth while for any nation to bleed to death in the defence of its currency, for fear of the adverse consequences of a devaluation forced upon it by the pressure of circumstances.

It is also important to bear in mind that the beneficial effect of inflation in France was obtained in spite of the absence of any economic planning. It is easy to imagine how much larger this beneficial effect would have been, if, given the fact that France had to inflate, she had carried out inflation systematically as part of her general economic programme. In such circumstances, inflation of a much more moderate degree would certainly have produced much more substantial additions to the national wealth. One of the reasons why France benefited by inflation in spite of the absence of planning was that a large part of the constructive influence of inflation was absorbed by the work of reconstruction which would evidently have been the main task that would have been undertaken had inflation been carried out in connection with economic planning.

(4) Inflation in Italy and Belgium

Another country where inflation was checked before it became destructive was Italy. During the war the resisting capacity of the lira was much weaker than that of the franc, and after the war the industrial situation and internal political troubles provided the main cause for its depreciation. After the advent of the Fascist regime, Signor Mussolini made considerable efforts to regain control of the lira, but so long as the franc was fluctuating this was impossible. There existed psychological links between the three Latin currencies, the French franc, the Belgian franc and the lira. Whenever the French franc appreciated or depreciated, the other two Latin currencies moved in sympathy. All the time, however, the lira was at a substantial premium against the franc.

In 1926, when M. Poincaré succeeded in checking the depreciation of the franc, the time arrived for Signor Mussolini to regain control of the lira. In a speech made at Pesaro in August 1926, he declared that he would defend the lira to the utmost, and the effect of this declaration was a sharp recovery. Subsequently the lira was stabilised at much too high a level, as a result of which, Italy deprived herself of the favourable

effects of moderate inflation, by which France benefited to such a high degree. About this, however, more will be said in Part II of the book.

In Belgium, inflation was inherited from the German occupation army, since the Government had to issue francs against the mark notes circulating in the country. As the exchange rate was fixed at a favourable level, large amounts of mark notes were smuggled in, thus increasing the initial degree of inflation. Subsequently the reconstruction of devastated areas and the Ruhr occupation caused the Belgian franc to depreciate to a much higher degree than the French franc. An attempt was made early in 1926 to stabilise it at a comparatively high rate, but the level chosen soon proved to be untenable, and subsequently the Belgian franc had to be stabilised at a much lower level. Thanks to this, industries had a prosperous time, and for years the price level in Belgium was easily the lowest in Europe.

The group of countries in which the depreciation of the currency attained a relatively moderate degree includes also Spain. Although, during the war, the peseta had a larger premium than any other neutral currency, after the war, budgetary deficits and internal political troubles, together with a prolonged and expensive war in Morocco, reduced its value considerably. The depreciation of the peseta began to assume large dimensions only after the other Latin currencies had been stabilised. Industries and the tourist traffic in Spain benefited to no slight extent by this belated inflation. In Portugal, political troubles made it impossible to balance the budget, until the advent of the dictatorship. Meanwhile, the escudo depreciated to a comparatively large extent.

(5) Intermediate Stage of Depreciation

Between the group including Central Europe, Russia and Poland, and the other group including the four Latin currencies, a third group occupies an intermediate stage. It includes the Balkan states, the Baltic states, and some Latin-American countries. The currencies of these countries depreciated to a larger extent than the group of Latin currencies, but not to anything like the extent of the Central European currencies. In the Baltic states the main cause of the depreciation was the initial difficulties that confronted the newly created states, and the dangerous neighbourhood of Soviet Russia, which inspired distrust in their currencies. In Roumania and Jugoslavia the inheritance of enemy

invasion and the complications arising from the unification of newly acquired territories with the old kingdoms, were responsible for the depreciation. In Greece inflation was due to the disastrous campaign in Asia Minor, and to the influx of a large refugee population from Turkey. In Bulgaria reparations payments were the main cause of the depreciation of the leva, which, however, was maintained within relatively moderate limits. In Turkey the prolonged warfare after the Armistice caused the pound to depreciate, though it displayed an unexpected degree of resistance.

In all these countries the currency depreciated to between about one-tenth and one-fortieth of its pre-war value. Although the classes with fixed incomes suffered to a large extent, they were not wiped out as in Germany or Austria. In most of these countries, economic and political conditions were too perturbed to enable them to benefit by inflation, though it was helpful in facilitating their settling down in the new conditions. In most cases the losses caused by inflation outweighed the beneficial effects.

(6) Effect of Limited Inflation

Apart from the effect of limited inflation upon the middle classes, which, regrettable as it is from a humane and social point of view, should not be overrated from an economic point of view, its chief disadvantage was in the unstable conditions amidst which it took place. There was a prolonged period of exchange fluctuations with all their unsettling effects upon foreign trade, and to some extent also upon home trade. Nor can inflation be credited with its constructive results without qualification. In innumerable cases, the rapidly rising trend of commodity prices led to the construction of industries without an adequate *raison d'être*. The depreciation of the national currencies provided a very effective customs barrier behind which inefficient plants were erected. Once they were there, they obtained full protection after the stabilisation of the currencies, and thus they were artificially bolstered up. Economic nationalism was to a large extent the outcome of the post-war currency chaos.

In this connection it cannot, however, be emphasised sufficiently that in every case inflation took place in an entirely haphazard way. No efforts were made to divert it into constructive channels, and if to some extent it produced constructive results, it was because of the inherent tendency of inflation to lead to the production of real wealth. In the almost com-

plete absence of economic planning, the beneficial effects of unorthodox finance were reduced to a minimum, and its destructive effects were increased to a maximum. For this reason, the net result produced should not be regarded as conclusive from the viewpoint of the constructive possibilities of unorthodox financial methods.

CHAPTER XI

REPARATIONS AND WAR DEBTS

(1) Effect of the War on International Debts

On various occasions in earlier chapters we have laid stress upon the predominant importance of excessive indebtedness as a factor determining the world's monetary situation after the war. Hitherto, we have confined ourselves largely to the effects of the increase of internal indebtedness. Let us now go a step further and examine the part international indebtedness play in post-war financial developments.

To a large extent the war led to a reduction of the indebtedness of pre-war debtor countries to the pre-war creditor countries. We have seen in Chapter IV that Great Britain, France and Germany financed their purchases from neutral countries during the war by mobilising the foreign security holdings of their nationals. In most cases the securities found their way back to the debtor countries themselves. At the same time the former creditor countries had to contract debts abroad. This process assumed particularly large dimensions after the entry of the United States into the war. From 1917 the United States Government undertook the charge of providing the funds for Allied purchases in the United States. The result was that at the end of the war the Allied Powers were heavily indebted to the United States, and to a much smaller extent to various neutral and overseas countries. Among the European Allies themselves also, huge amounts of debt had been contracted. Great Britain financed to a large extent all her continental Allies, including France, who in turn granted substantial loans to the other continental Allies. As for the Central Powers, they were unable to contract any heavy debts in neutral countries during the war, so that their external indebtedness at the time of the Armistice was relatively moderate. On the other hand, the peace treaties landed them with immense burdens of reparations far in excess of the total amount of inter-Allied indebtedness to the United States.

In addition, further international indebtedness was contracted after the Armistice as a result of the prolonged hos-

tilities in various parts of Europe. There was the Czechoslovak and Roumanian campaign against the Hungarian Soviet Republic; there was the Greek campaign against Turkey; and there was the fight between the various border states and Soviet Russia. Lastly, the establishment of new States under the peace treaties was accompanied by a certain amount of international lending, and financial relief was provided for countries which were particularly affected by adverse conditions prevailing during the first few post-war years. All this financing assumed the form of inter-Allied indebtedness.

(2) Problem of Transfers Ignored

By the time peace was established all over Europe, the burden of these international debts had assumed gigantic proportions. None of the post-war statesmen gave serious consideration to the question of how the payment of all these debts could be made practicable. The problem of international transfers was wholly ignored at Versailles, and in the subsequent international agreements until 1924. The creditors were vaguely aware that their debtors could only pay through a surplus of exports. Notwithstanding this, no efforts were made either to facilitate the expansion of their exports by debtor countries or to limit the payments required to the export surplus available for transfer. The result was what ought to have been expected. The debtors were unable to pay their debts; all that happened was that new debts of a different kind were contracted in order that the debtors might be able to make payments on the existing debts.

In Chapter IX we have seen how excessive reparations demands were responsible for the collapse of the mark. This experience provided a warning which the post-war statesmen, however unwilling or unable they were to face realities, could not ignore. Until 1924, at the various international conferences that followed each other in close succession, nothing practical was done to find even a provisional solution. Things were simply allowed to drift, and no efforts were made to establish some sort of system in the chaos of international indebtedness.

(3) The Reparations Deadlock

The story of reparations and inter-Allied debts is probably the best-known section of post-war financial history. Everybody knows the circumstances in which the short-sighted statesmen of Versailles forced Germany to undertake the payment of sums which they ought to have known she would

never be able to pay. Everybody knows how the United States, by a rigid insistence on collecting her claims on the Allies, made it extremely difficult for the latter to make substantial concessions to Germany, even if they wanted to do so.

This deadlock was largely the result of the efforts to reconcile President Wilson's Fourteen Points with the realities of the Allied victory. As a result of President Wilson's attitude, it was impossible to dictate to Germany a frankly annexationist treaty. The desire of the victorious powers, especially of France, to keep Germany in a position of inferiority, so as to prevent her from repeating her aggression of 1914, had to be disguised behind the financial clauses of the treaty. It was hoped in Paris that by fixing reparations at a fantastic figure it would be possible to prevent Germany from recovering her strength and it would be possible to provide an excuse for France to keep her in permanent subjection. A frankly annexationist treaty without such financial clauses would have been much less troublesome both for Germany and for the rest of the world. It took France thirteen years to realise that the hopes of keeping Germany in subjection indefinitely were illusory. Meanwhile, the world had to suffer through the powerful disturbing influence of reparations. As for the United States, up to this very day, she fails to realise adequately her mistake in insisting on payment without providing the possibility of making payment.

(4) "Political" Indebtedness

To realise the short-sightedness of post-war statesmen, it is necessary to compare their attitude with that of the peace-makers of 1814–15. The Vienna Congress may have made many grave mistakes, but it certainly avoided crippling Europe by inserting impossible clauses in the treaty. Such reparations as were claimed from France after Waterloo were forgiven four years later, while the debts of the continental allies of Great Britain met with a similar fate. It is sometimes argued by the apologists for the peace-makers of 1919 that their position was more difficult than that of their predecessors of 1815, for there was no need for Castlereagh and his contemporaries to please a large electorate thirsting for revenge. If this is so, it throws a strange light upon democracy as a factor for peace.

It is argued sometimes that the problem of the political indebtedness ought to have been simplified from the very outset by the unilateral default of the Allies upon war debts to the United States. The decision of the British Government

to honour its indebtedness to the United States in 1922 has been the subject of bitter criticism. In this respect, as in many other respects, the survival of pre-war ideas in conditions which were totally different from those prevailing before 1914 was responsible for the mistaken policy. A default was something unthinkable to a British Government in 1922. It took eleven years before the inevitable necessity for default was realised. It may be argued perhaps with some conviction that it was necessary to make at least an attempt to meet the liabilities.

(5) International Transfers and Trade

However it may be, the world was confronted with a transfer problem which was impossible to solve. Throughout the history of modern financial evolution, international indebtedness has tended to increase, but the volume of international trade has more or less kept pace with it. Now, all of a sudden, after the war, international indebtedness was increased by many milliards, while at the same time the increase of economic nationalism tended to handicap the development of international trade. The anomaly was even more glaring than that of the increase of internal indebtedness coupled with the effort to raise the value of the monetary unit to its pre-war level. It was possible to disguise this anomaly for years behind a screen of reckless international lending, but sooner or later the edifice was bound to collapse unless, by some miracle, means were found to multiply the volume of international trade, or unless the real burden of the international indebtedness was reduced through an adequate reduction of the commodity value of the monetary units in which these debts were contracted. Miracles do not as a rule happen in the Twentieth Century, and nobody acquainted with conditions prevailing after the war could seriously have anticipated a sufficient increase in the volume of international trade to enable debtors to discharge their liabilities without contracting new ones.

The only practicable alternative was, therefore, the reduction of the value of the monetary units. Unfortunately, the principal creditor country, the United States, was in a strong financial position which enabled her not only to maintain but also to increase substantially the commodity value of her currency. While the European debtor countries could have reduced the burden of their internal indebtedness by allowing their currencies to depreciate, so long as the commodity value of the dollar was maintained and increased the result would

have been an increase of the burden of their international indebtedness. This would have offset, to a large extent, the beneficial effect of a reduction of the burden of their internal indebtedness.

(6) If the Dollar had been Devalued

Early in 1920 the rising trend of commodity prices in the United States was tending to provide automatically the desired solution. Had the rise been allowed to continue, and had it been perpetuated by a devaluation of the dollar, the European debtors would have found no difficulty in discharging their liabilities, and Germany would have found it easier to pay reparations. Unfortunately the solution was too good to be adopted. If the European belligerent countries with their huge indebtedness growing out of proportion to the national wealth were unwilling in 1920, and even much later, to realise the necessity of devaluing their currencies, can the United States with her immense financial and economic resources be blamed for having omitted to devalue the dollar? The question did not even arise. It did not occur to anybody to suggest such a solution, and had such a suggestion been made it would not have received consideration. The world was fated to learn its lesson at its own expense. Unfortunately, it is doubtful whether, in spite of having paid a tremendous fee in the form of superfluous sacrifices and sufferings, mankind has adequately understood the lesson.

With the relapse of commodity prices in 1920, the only chance of a solution of the international debt problem disappeared. The commodity value of the international indebtedness continued to rise almost incessantly until March 1933, when the depreciation of the dollar provided some relief. By that time, the real burden of the debts was practically twice as much as it was at the time of their contraction.

Compared with this movement of fundamental importance, the haggling over war debts and reparations that took place between 1919 and 1929 appears relatively unimportant in the perspective of history. The reduction of the total of reparations in the Young Plan compared with the Dawes Plan, impressive as it may seem, was offset by the increase of the burden through the fall of commodity prices. The concessions made by the United States to some debtor countries in the Debt Funding Agreements were barely sufficient to offset the increase in the burden of war debts through the appreciation of the monetary unit.

To a very large extent, reparations were responsible for post-war inflation. Their share in the responsibility for the collapse of the mark was adequately dealt with in Chapter IX. But for the imposition of debts upon Germany far beyond her capacity to pay, it might have been possible to check inflation before it had reached an extreme stage. The same may be said to be true to a lesser degree about Austria and Hungary. Even in the case of France, it was the anticipation of reparation payments that led to unduly extravagant inflationary expenditure in connection with the reconstruction of devastated areas. To that extent, responsibility of reparations for post-war inflation can be distinctly traced. In addition, both reparations and war debts created a situation of uncertainty for debtors and creditors which produced a psychological factor detrimental to financial stability.

We shall see in later chapters that the attempt to stabilise currencies failed to a large extent because of the omission to settle the problem of reparations and war debts before proceeding with stabilisation. We shall also see that these international debts, a large part of which originated through reparations, played a fateful part in bringing about the world crisis. We shall also see that the maldistribution of gold, which was largely the result of reparations and war debts, played a decisive part in bringing about the slump.

CHAPTER XII

SUMMARY OF PART I

(1) Characteristics of War-time Inflation

In the course of the past nine chapters we have tried to give an account of the evolution of inflation after 1914. We have seen that during the war the creation of additional purchasing power through unbalanced budgets led to an inflationary rise in prices which, however, was relatively moderate, until the advanced stages of the war, owing to measures of control and to the inadequate degree to which the existence and the real nature of inflation was realised. We have seen that this ignorance of what was happening characterised not only the attitude of the public but also that of Governments. They, like Christopher Columbus or President Roosevelt, did not know whither they were going, and when they arrived, they did not know where they were. This was one of the characteristics of war-time inflation.

Another important characteristic of inflation between 1914 and 1928 was that it was brought about for essentially unproductive purposes. While it is true that with the aid of the artificial purchasing power created goods to the value of untold milliards were manufactured, these goods served not to increase but to destroy real wealth. Thus, there was no increase in the production of real wealth to keep pace with the increase in the volume of purchasing power. In fact, the volume of real wealth was declining rapidly at the same time as a huge additional purchasing power was placed in the hands of the public.

Yet another characteristic of the war-time inflationary period was that its effects were to a large extent concealed, and that they did not manifest themselves to their full extent until some months after the cessation of hostilities. In addition to artificial measures such as price fixing and rationing, the conception that all the changes were purely temporary and would disappear as soon as the war was over, was largely responsible for the delay in the effects of inflation.

(2) Post-War Inflation and Slump

This conception that, after the war, everything was bound to return to normal was responsible for the temporary fall in prices that followed the Armistice. Before long, however, the rise in prices was resumed all over the world, and by the spring of 1920 post-war inflation was beginning to assume spectacular dimensions. In addition to the belated effects of war-time inflation the existence of budgetary deficits and an urgent demand for goods by those who had had to do without them during the war were the main factors responsible for the rapid rise in prices. The rise was accompanied by an expansion of banking credit, which, however, was the effect rather than the cause of inflation.

The movement came to an end as a result of deflationary measures taken by the monetary authorities of the leading countries, especially of the United States, Great Britain and Japan. During the summer and autumn of 1920 there was a heavy slump in commodity prices as a result of high bank rates and credit restrictions which forced producers and merchants to throw their stocks on the market. The slump continued during the first quarter of 1921. It was practically as universal as was the rise in commodity prices during and after the war. Even in countries which continued to inflate through budgetary deficits there was a heavy relapse in prices.

From 1921 onwards, however, the world became divided into two groups of countries according to whether the deflationary movement that began in 1920 continued or whether the post-war inflationary movement was resumed. The first group included Great Britain, the United States, Japan and most European neutral countries; the second group included all continental belligerent countries, with the exception of Czechoslovakia. Within this group the degree of inflation varied widely, the one extreme being represented by Germany, Russia, Austria and Hungary, where inflation assumed an extreme degree, and the other extreme represented by the group of Latin countries where inflation assumed a comparatively moderate degree.

Post-war inflation was also characterised by an utter lack of deliberate policy. It occurred in a haphazard way without any efforts on the part of the authorities to make use of it for productive purposes. To some extent it had productive results, especially in France, notwithstanding the complete absence of any deliberate action to take advantage of inflationary expansion to that end.

(3) Effects of Inflation

Let us now give a summary of the effects of inflation during and after the war. Its immediate effect upon the budgetary situation was to increase further the deficits, since it increased expenditure without being able immediately to increase revenue to a corresponding degree. Taking a long view, however, where inflation was not followed by a high degree of deflation it provided a welcome relief to the exchequer, for revenue gradually adjusted itself to the higher level of prices, while one particularly important expenditure item, that of the service of the public debt, remained nominally unchanged, which meant that its real burden declined. It is true that as a result of higher prices, public debt increased to a larger extent than it would have done otherwise, but in most countries the increased total represented a smaller real burden.

The effect of inflation upon production varied widely according to its degree. During the earlier stages and in countries where it never assumed an advanced stage the effect was decidedly beneficial. Apart from the increase in the output of consumption goods, the result was a considerable increase in productive capital invested in the form of new industrial plants, dwellings, etc., in spite of the fact that inflation was not deliberately engineered for the purpose of bringing about such productive results. In countries where inflation attained an advanced stage, its result was highly detrimental to production. While it lasted, chaotic monetary conditions paralysed business activity, and when it was over, its effect manifested itself in an acute lack of working capital. While inflation at its moderate stages tends to reduce indebtedness, once it reaches an advanced stage, it tends to increase indebtedness by making it necessary to reconstruct the capital destroyed.

(4) Effect on Banking and Exchange

The effect of inflation upon the banking system also varied according to the degree it assumed in various countries. In countries such as France, banks benefited by the increased productive activity and had an opportunity for accumulating huge hidden reserves. In countries such as Germany, extreme inflation depreciated the capital resources of banks, which, together with industrial undertakings, had to raise fresh capital after stabilisation. In no case has inflation led to bank failures while it lasted, since during a period of rising prices the amount of losses through bad debts is negligible. At the

same time, once inflation was over, the readjustment to stable conditions was in most countries accompanied by a series of bank failures. The banks affected were mostly the mushroom growths that sprang up during inflation, but in a number of countries well-established banks got into unsound hands during that period, and had to disappear as soon as inflation was over.

The effect of inflation was highly detrimental to the stability of exchanges. To a large degree, the extent of inflation influenced the exchange value of various currencies. On the other hand, it is equally true that, to a large degree, the exchange value of currencies reacted upon the development of inflation in various countries. Whenever an exchange depreciated through flight of capital or reparations payments, the result was a rise in the inland price level in the countries concerned, which again tended to accentuate inflation. Inflation of currency and inflation of prices were running concurrently. It is, nevertheless, beyond doubt that, taking a long view, the main factor was internal inflation. To the extent to which it reacted upon exchanges, it affected adversely international trade. It is largely owing to exchange dumping that a number of countries resorted to increased protective measures. At the same time, the natural protection provided by a depreciated currency was largely responsible for the industrialisation of many agricultural countries. Through its effect on exchanges, inflation was largely responsible for economic nationalism after the war.

(5) Speculation in Exchanges

The chaotic state of the exchanges was largely accentuated by the wave of reckless speculation that seized the world immediately the exchanges were unpegged in 1919. During the war, speculation in exchanges had relatively little scope, especially as far as the principal Allied exchanges were concerned as they were held firmly by the authorities. As soon as the control was removed, the natural fluctuations which were unchained attracted large classes of professional speculators whose operations accentuated to no slight extent the upward and downward movements. Subsequently the general public began also to take a hand and gambling in exchanges assumed gigantic proportions. We have seen how bull speculation in marks contributed towards prolonging the agony of the German currency. We have also seen how bear speculation in the French franc made France realise the adverse consequences of her Ruhr adventure. Other currencies were also

subject to heavy speculative operations from time to time, and this factor added to no slight extent to the currency chaos. It provided an additional reason why inflation was essentially destructive since any attempt at controlling it was from time to time upset by speculators. It is true that in theory, at any rate, speculative operations can have only a temporary effect upon the exchange, since sooner or later they have to be covered, in which case the tendency they provoke may become reversed. In practice, however, the influences provoked by speculative operations may produce a lasting change in the general situation, so that even if and when the speculative operations are reversed, the result remains.

At the time of the post-war currency chaos, the adverse effect of speculation and of the flight of capital from country to country was not yet adequately realised. If any measures were taken against them at all, they were highly inadequate. In most countries nothing was done to prevent speculation or to regulate its effect. It was not until many years later that a more or less watertight system of exchange control was elaborated by several countries, with the aid of which they were in a position to safeguard themselves against the speculative exaggerations of economic tendencies. One of the reasons why inflation produced such disastrous results in many countries after the war was exactly this freedom with which speculation was allowed to produce its mischievous effect.

(6) Is Inflation Necessarily Disastrous?

It would be idle to pretend that inflation, if it assumes an advanced degree, does not necessarily lead to disastrous results. On the other hand, it would be equally misleading to take it for granted that every inflationary move, however moderate and well planned, inevitably leads to disaster similar to that experienced in various countries after the war. It might be borne in mind that the circumstances in which inflation took place between 1914 and 1926 were such as to accentuate to the extreme the adverse influences of the movement. If and when inflation takes place again as a result of a prolonged and expensive war and internal upheavals, then its results will be just as disastrous as those of post-war inflation. Even then the disastrous consequences would be offset, to some extent at any rate, by the technical progress which has taken place since the inflationary experience of the war and post-war period. The productive capacity of the world, both in industry and in agriculture, has increased

immensely since the war. At that time, productive capacity was particularly low, owing to the disorganised conditions created by the war. In the meantime, technical and chemical inventions and the adoption of rationalised methods have increased the productive capacity of the world to an amazing extent.

This means that if ever in future artificial purchasing power is created on a similar scale to that during and immediately after the war, to a large extent this will be accompanied by a spectacular increase in industrial and agricultural production, unless such an increase is prevented by the abnormal conditions prevailing during a war or a civil war. Otherwise, even a reckless inflation would fail for some time to cause a spectacular rise in prices under peace conditions owing to the expansion in the output of goods. It is only if the creation of artificial purchasing power assumes such a degree as to make it impossible for production to keep pace with it that conditions prevailing during and after the war will repeat themselves. This does not mean that in existing conditions even a relatively moderate inflation would not be destructive. In the absence of adequate economic planning, it would almost certainly lead to disequilibrium between the various branches of production and between production and consumption, so that in the long run it would inevitably lead to a slump.

(7) Inflation and Planning

If inflation is maintained within moderate dimensions and is kept under control, and if it takes place in a community where production and distribution are subject to scientific planning, there is no reason whatever why it should produce the evil consequences witnessed during and after the war. It is essential that the authorities who control the creation of purchasing power should also control production and distribution. This is the point which is usually overlooked by would-be currency reformers. They think that by simply juggling with currency all the world's troubles can be brought to an end, without having to change for that purpose the fundamental economic structure of the community. They think that all the nations would have to do would be to keep on expanding their currency and live happily for ever after. It is such theories that discredit any serious attempt to bring about a change for the better. For it is obvious to everybody but the currency cranks themselves who put forward such propositions that continuous expansion of currency unaccompanied by plan-

ning in production and distribution inevitably results in disequilibria on a gigantic scale, which eventually is bound to lead to disastrous crises. If conditions remain even moderately prosperous for several years, producers, business men and speculators tend to become recklessly optimistic and the result is over-production in many directions. Such over-production is not necessarily absorbed by a fresh increase in the creation of purchasing power, for if the wrong kinds of goods are produced, or if the purchasing power is directed into the wrong hands, the goods remain unsold. It is not until the community is provided against such dangers as far as it is possible, with the aid of planning, that it is safe to expand purchasing power.

(8) Inflation and Fictitious Wealth

Inflation during and after the war was mainly responsible for the creation of the gigantic fictitious wealth which now weighs heavily upon mankind. This is another consideration which fanatic expansionists usually overlook. While the fictitious wealth is being created through inflationary expansion, it finances an increase of production and consumption, but once the process is completed, the additional fictitious capital remains as a dead-weight burden. It is only during the process of its creation that fictitious wealth is beneficial, and once it exists it becomes a burden. The question is whether the credit side of the balance sheet of human wealth has increased sufficiently to compensate mankind for this increase of fictitious wealth. This was certainly not the case during the war. The goods created through an expansion of fictitious wealth were destroyed, and were used for destroying existing goods. While on the debit side of the balance sheet of inflation during and after the war there is a huge expansion of fictitious capital, on the credit side in most countries there is very little to compensate for this increase.

The extent to which post-war inflation offset the disequilibrium between fictitious wealth and real wealth created by war-time inflation varies according to countries. In France, where post-war inflation served largely productive purposes and was diverted into the creation of capital goods, the result was highly satisfactory. It is true that between the Armistice and the stabilisation of the franc, the nominal amount of fictitious wealth in France increased considerably. At the same time, however, the depreciation of the franc reduced the real burden of that increased total. In addition, on the credit side of the balance sheet, real wealth of a lasting nature

increased as a result of inflationary expansion of fictitious wealth. Other countries were on the whole less fortunate, some of them because they went too far in the depreciation of their currencies, and others because they did not go far enough ; in most countries, post-war inflation financed mainly the production of consumption goods and not of capital goods, so that the result on the credit side of the balance sheet disappeared, while the result on the debit side of the balance sheet remained.

The experience of the world during and after the war has taught us how not to inflate. The experience of the subsequent years has taught us how not to stabilise. It is this second lesson that will be examined in Part II of this book.

PART II

STABILISATION

CHAPTER XIII

WHAT IS STABILISATION?

(1) The "Good Old Days"

The century that elapsed between the end of the Napoleonic Wars and the beginning of the Great War was characterised by an unusual degree of financial stability. This does not mean that everything went smoothly as the eulogists of the "good old pre-war days" are inclined to assume. From time to time, there were financial crises of considerable gravity. Every now and again the world was shaken by some bank failure that had wide repercussions. Monetary stability was undisturbed in well-established countries such as Great Britain and France, but countries such as Austria-Hungary, Russia, etc., experienced devaluations; countries such as the United States and some of the Latin-American states experienced inflation on a large scale; countries such as Italy, Spain, etc., witnessed a relatively moderate depreciation of their currencies. From time to time Governments suspended the payment of their internal debts and less frequently also that of their international debts.

Notwithstanding this, the Nineteenth Century and the early part of the Twentieth Century were entitled to be regarded as an essentially stable period from the financial point of view. Departures from stability were the exception and not the rule, and all the time, the world had a fixed point constituted by the important group of leading countries whose currencies remained stable in relation to gold. The progress towards the universal adoption of the gold standard during the last quarter of the Nineteenth Century was a further cause of the increased stability of world finance. Even though the uniformity of the monetary systems was more apparent than real, since in every country the gold standard was interpreted and applied in a different sense, it undoubtedly was the common basis upon which the international structure rested.

(2) No Return to Pre-War Conditions

We have seen in Part I of this book how the world departed from 1914 onwards from the state of comparative stability

existing before the war. We have seen that during the war and also to some extent after the war, statesmen and economists regarded the return to pre-war conditions as an ideal towards which the world had to strive. During the war it was taken for granted that pre-war financial conditions would be restored almost without any material change as soon as hostilities were over. This optimism gradually vanished in the light of post-war experience. With the progress of years, it was gradually realised by every country that if and when stability in the world was restored, it would be a rather different kind of stability from that prevailing before the war. The differences were considered, however, to be of secondary importance only. In many countries, the mint parity had to be changed. In most countries the gold standard to be adopted was a different system from the one prevailing before the war. There were other differences of detail, but in spite of that, the world was convinced that it was working its way towards the restoration of a system which would be substantially the same as the pre-war system.

(3) Stability of Exchanges *v.* Stability of Prices

It is true there were people who questioned whether it was possible or desirable to return to the pre-war system. There was a school of thought developing after the war according to which stability should mean something totally different from what it meant in pre-war days. To the pre-war economist, stability meant the stability of exchanges, and mint parities. To a very important school of post-war economists it meant the stability of commodity prices. They proposed that the monetary unit should be kept stable in terms of commodities rather than in terms of gold. Above all, they supported the view that the possibilities of monetary expansion should not be determined by the quantity of monetary gold available but by genuine commercial requirements. Although the various schemes of monetary management differed from each other, they all agreed that in future stability should mean the absence of wide fluctuations of commodity prices.

This movement was of purely academic interest, however. The overwhelming majority of statesmen, bankers and economists were convinced that the pre-war system was the nearest to the ideal that we can ever hope to achieve, and the public in general had taken it for granted that the pre-war system would be restored. There was, indeed, no serious opposition anywhere to the efforts to stabilise on more or less

pre-war principles. To the minds of the general public, stability still meant a fixed relationship between the monetary unit and a given quantity of gold. Although the opposite thesis was represented by some of the most prominent thinkers in the post-war period, their ideas failed to gain popularity among the masses.

Nor was the moment for launching out a campaign in favour of managed currency particularly well chosen. The world judges by results and it was too much to expect public opinion to forget that everything went comparatively well while the world was on a gold basis, and things went hopelessly wrong when it abandoned that basis. In the minds of the generation which was old enough to remember pre-war conditions, stability, prosperity and happiness were associated closely with the idea of the gold standard. To suggest that inconvertible paper currency should be perpetuated amounted to suggesting a perpetual currency chaos. Indeed, any idea of a deliberate and fundamental modification of the pre-war system was viewed with suspicion.

(4) The Choice of Parities

To the minds of practically all statesmen in responsible positions after the war, it was the supreme task of all Governments and Central Banks to do their utmost to return to the gold standard as soon as possible. The only difference between the two great groups of countries, one of which continued to inflate after the slump of 1921 while the other adopted a deflationary policy, was regarding the rate of stabilisation. Countries of the inflationary group gradually came to realise that there was no hope of their restoring their currencies to their pre-war parities. The countries of the deflationary group, on the other hand, pursued the object of restoring pre-war parities. There was absolutely no co-ordination between the various stabilisation schemes. The choice of the parities was made with an almost complete disregard of the economic parities of currencies and with a complete disregard of international considerations. Even less attention was paid to the effect of the choice upon the burden of the public debt.

We have seen that during and after the war inflation was an entirely haphazard movement without any planning and control, and that consequently it showed itself at its very worst. The same may be said to hold good about post-war stabilisation. The world-wide tendency to restore stability was allowed

to materialise without the minimum amount of planning that was necessary. It did not occur to anybody to consider whether the rate of stabilisation chosen by one country or another would not produce grave repercussions upon the situation of other countries. It did not occur to anybody to examine whether the wholesale adoption of the gold standard by the largest possible number of countries would not produce a scramble for gold with disastrous results. Nor did it occur to anybody that at the rates of stabilisation chosen, the burden of the public debt might prove unbearably heavy. " Stabilise as soon as possible at no matter what rate " was the password, and nobody worried about the consequences.

(5) Ill-Considered Stabilisation

Few people realised that this movement of stabilisation in the circumstances in which it occurred unchained influences which in the long run were fated to defeat its object. In the great haste with which various countries sought to put an end to the inconveniences of an unstable currency, they failed to realise that stabilisation can also have its inconveniences, which in given circumstances may assume such dimensions as to reduce the whole system *ad absurdum*. This anxiety to stabilise at all costs and as quickly as possible is easily understandable. People are always inclined to exaggerate the inconveniences of the existing system and the advantages of a past or a future system, and they are equally inclined to minimise the advantages of the existing system and the disadvantages of a past or a future system.

A similar tendency is noticeable also at the time of writing. The world is getting tired of the instability of currencies, and there are many people who urge immediate stabilisation. Apparently the lesson taught by the utter failure of the post-war stabilisation movement was entirely lost on them. They are ready to commit the same mistake which was committed between 1922 and 1927. Fortunately, the statesmen who are responsible for the decision are now more cautious. They are determined to avoid if possible the repetition of the mistake they or their predecessors made.

(6) Why Stabilisation Attempt was Doomed

In the circumstances in which the currencies were stabilised after the war, a relapse into instability was a mere question of time. Neither the fundamental conditions of stability nor the technical conditions for its defence were present. It ought to

be borne in mind that pre-war stability was not the result of monetary stability. On the contrary, monetary stability itself was the result of the more fundamental stability of political and economic conditions between 1815 and 1914. Although the Nineteenth Century had its wars and revolutions, their extent could not be compared with either that of the French Revolution and the Napoleonic Wars or with that of the Great War and the upheaval that followed it. The economic situation was characterised by a process of comparatively slow evolution. There were relatively few jumps and jerks in the progress of the economic system to unsettle equilibrium and to cause monetary instability. But for these conditions of fundamental equilibrium it would have been impossible to maintain the stability of the financial superstructure for any length of time.

It is important to bear this fact in mind because it leads us to the discovery of the fundamental error that caused the failure of the attempt at general stabilisation after the war. Those responsible for the movement towards restoring stability committed the error of mistaking the effect for the cause. They thought that in establishing stability on the surface by pegging the various exchanges to gold they would succeed in restoring pre-war stability. They failed to realise that before the war it was the fundamental stability of conditions which made it possible to maintain monetary stability, and that without the return of that fundamental stability it was hopeless to attempt to stabilise currencies.

(7) Fundamental and Technical Conditions

The fundamental conditions of stability require, in addition to general political and economic stability, the existence of a reasonable degree of equilibrium on the basis of the rates of stabilisation chosen. There should be an approximate equilibrium between the amount of fictitious wealth and real wealth. If the level of stabilisation chosen is too high, the burden of an excessive fictitious wealth will weigh upon the world and prevent the stabilisation of conditions in the real sense of the term. If the level of stabilisation is excessively low, too much of the fictitious capital required for normal working of the economic system is destroyed, and this again provides the temporary obstacle to the normal functioning of the system. It is also necessary that there should be a reasonable degree of equilibrium between price levels in various countries, or if there is some disequlibrium between them, conditions should be such as to make a readjustment possible.

The chief technical condition for the defence of stability is an adequate amount of gold reserve, reasonably well distributed among various countries, and the willingness of those possessing favourable balances of payment to re-lend the surplus. None of these conditions, fundamental or technical, was present to a sufficient degree. The level of stabilisation failed to secure equilibrium internally or internationally. In some countries, the level of stabilisation was unduly low, as an inevitable result of extreme inflation. The necessity of reconstructing their destroyed capital resources provided a strong element of uncertainty. Another element of uncertainty was introduced by the stabilisation of some currencies at an unduly high level. Internally this caused the burden of public debt to remain too heavy, while internationally it resulted in a discrepancy between price levels of countries with over-valued and under-valued currencies. Thus, while on the surface the system of stability appeared to be similar to the system prevailing before 1914, under the surface there was a fundamental disequilibrium in more than one direction which threatened to undermine the surface stability.

From a technical point of view, the conditions of the defence of stability were also highly inadequate. Given the fact of the increase of fictitious wealth and of the introduction of a variety of potential sources of instability, the total amount of the world's monetary gold stock was insufficient to meet requirements. It is not only that, owing to the maldistribution, some countries had rather less than their due share of the gold stocks, but that the total itself was far beneath the increased requirements. Nor did the countries which attracted gold through their favourable balances of payment show a sufficient degree of willingness to re-lend their surplus.

(8) International Co-operation

In the circumstances, it was unduly optimistic to imagine that by the mere fact of stabilising the currency it would be possible to restore the stability of world finance in the pre-war sense of the term. Many responsible statesmen and bankers must have realised how fragile this newly established stability was. They sought to make up for the lack of fundamental equilibrium and for the weakness of technical means of defence by establishing closer co-operation between Central Banks. Had they succeeded in establishing co-operation in the true sense, it might have been possible to bolster up the untenable position created by fundamental disequilibrium

during a certain number of years. In the long run, however, even the most thorough-going co-operation would have been unable to stand the test of having to resist the constant pressure caused by the lack of equilibrium. The edifice of post-war stabilisation was bound to crumble sooner or later, and it was perhaps a blessing in disguise that the inevitable collapse was not postponed beyond 1931.

The attempt of international stabilisation after the war was doomed to failure because it was built upon an essentially superficial and mistaken conception of stability. We pointed out above that, with the exception of a few economists, everybody regarded stability of exchanges in relation to gold as all-important and stability of commodity prices as of relatively small importance. Before the war, there was no obvious conflict between the two. Although commodity prices were far from stable, their upward and downward movements were on the whole gradual. Rightly or wrongly, it was believed that the best way of avoiding violent fluctuations of commodity prices was to maintain the stability of exchanges in relation to gold. In the light of post-war experience it has become obvious that from time to time the world will have to choose between stability of prices and stability of exchanges. This was not realised at the time of post-war stabilisation: the world had to learn it at its own expense several years later.

CHAPTER XIV

THROUGH DEFLATION TO STABILITY

(1) The Dollar's Supremacy

During and after the war the United States acquired a unique position in the international monetary sphere. Thanks to the accumulation of a huge gold reserve and of a still larger amount of claims on foreign countries, and thanks to her persistently favourable trade balance, the United States had become the arbiter of the world's monetary destinies. After having suspended the gold standard for a short while by placing an embargo on gold exports, the United States restored the dollar to a gold basis soon after the war, and from that time onward until the stabilisation of the franc in 1928 the dollar fulfilled the functions of the basic currency to which all other currencies had to adjust themselves. Whatever monetary policy was pursued in the United States it inevitably affected all other countries except perhaps those in which inflation attained a sufficiently advanced stage to detach the price level from the world level.

During the slump of 1920 and 1921 it was mainly the deflationary monetary policy of the United States that dictated the pace. Had the British monetary authorities refrained from taking deflationary measures, a slump would have taken place nevertheless in Great Britain, though its extent would have been doubtless much more moderate. The result of the difference in the degree of deflation would have been a depreciation of sterling in terms of dollars, which was exactly what the British authorities were most anxious to avoid. Given the fact that they aimed at restoring the sterling-dollar rate to its pre-war parity, they were bound to follow the policy pursued by the United States, and this in spite of the fact that conditions in Great Britain were totally different from those prevailing in the United States. Although public debt increased considerably in the United States during the war, it remained far below the figure of the British public debt. The difference was still more marked if we take into consideration the superiority of the actual and potential national wealth of

the United States. What is more, in the United States the increase of the public debt was partly offset by a decrease in private indebtedness and through the repatriation of external pre-war debts. If there was one country, therefore, which could afford to restore its currency to its pre-war value it was the United States. For considerations of prestige and in pursuance of century-old traditions, the British authorities never even considered the idea of fixing a definite value of sterling below its pre-war parity with the dollar, although the changed situation would have amply justified such a policy.

(2) The Gold Stock of the United States

Once the slump was over in 1921, the monetary policy of the United States ceased to pursue a deliberately deflationary policy. At the same time, it is impossible to get away from the fact that the huge gold reserve accumulated during and after the war remained largely sterilised. No skilful juggling with figures of bank deposits and credits can obscure the fact that the reserve ratio remained throughout the post-war period at an abnormally high level. This policy has often been explained as the result of the desire of the United States to treat the influx of gold as "a deposit which sooner or later would have to be restored to its owners". This conception was, however, entirely fallacious. By sterilising this so-called gold deposit, the United States effectually prevented it from finding its way back to its so-called rightful owners.

Had the gold been allowed to serve as a basis for a corresponding expansion of credit, the result would have been a rise in prices in the United States which would have facilitated the repatriation of gold. It is true that a rise in commodity prices in the United States would have provoked an upward trend all over the world, but American prices would have held the lead. Such a policy would have obviated the necessity for other countries desirous of restoring their currencies to their pre-war parities to deflate to that end. Thus, in addition to facilitating the redistribution of gold, it would have obviated the necessity for deflation in a number of countries, and at the same time it would have reduced the commodity value of debts, internal and international alike.

Had the American authorities possessed prophetic foresight enabling them to see the disastrous consequences of the deflation which the world had to undergo in the absence of an adequate degree of inflation in the United States, they would not have hesitated to adopt the right solution. It

was, however, too much to expect of them to view things in 1921 with eyes of 1935. At that time, it must have appeared unthinkable that they should go out of their way to inflate deliberately in the United States or, at any rate, to allow the natural trend towards expansion to take its course, merely in order to obviate the necessity for Europe to deflate, or to facilitate the task of their debtors to pay their debt. The development of such an international conception of monetary policy could only be achieved at the cost of bitter experience. The United States, like other countries, had to learn at its own expense that a monetary policy guided exclusively by narrow national considerations was bound to recoil upon the nation itself. With the knowledge we possess to-day, it is evident that it would have been to the interest of the United States to inflate and to devalue the dollar after the war instead of deflating and thus forcing the world into a deflation which eventually inflicted a grave economic crisis upon the United States.

(3) Deflation in Great Britain

Given the fact that the United States pursued a policy aiming at maintaining a high value of the dollar in terms of commodities, and given the fact that the British authorities were determined to restore sterling to its pre-war parity, it was inevitable that in Great Britain stabilisation should be preceded by deflation. To a large extent the post-war slump itself had already produced a deflationary effect, as it wiped out a large part of the surplus purchasing power created during the war. Crushing taxation also worked in the same way. In addition, the Government's officially declared monetary policy was also deflationary. The recommendation of the Cunliffe Committee to reduce the note issue by making the minimum figure of one year the maximum limit of the following year was adopted.

It is characteristic of the casual way considerations of monetary policy of fundamental importance were treated in those days that no legislation was passed to that end ; it was considered sufficient to pass Treasury Minutes determining the fate of sterling for many years. Public opinion failed to take any interest in the matter, and failed to realise what the deflationary policy meant. There was practically no resistance to this policy which was taken over and pursued even by the Labour Government in 1924. The only resistance came from the Midland Bank, whose chairman, Mr. McKenna, adopted

the policy of keeping the largest possible amount in cash, so as to prevent a reduction of the maximum limit of the note issue to too low a figure.

(4) Optimistic Assumptions

It was not so much the actual deflationary effect of this monetary policy as its psychological influence that brought about a steady recovery of sterling throughout 1924 and 1925. Once it was evident that the British Government had made up its mind to return to pre-war parity, the foreign exchange market took it for granted that it would be able to achieve this end. The mere anticipation of the success of the official British policy was sufficient to cause sterling to rise. There was no need for the authorities to take any active steps. Sterling was driven back to its parity by speculative buying before the actual decree of deflation justified such an appreciation. Presumably, it was the facility with which the authorities attained their end that encouraged them to take an unduly optimistic view about their capacity to maintain sterling stable at its pre-war parities. They did not realise that just because the return to pre-war parity was so easy, its maintenance at that level would be very difficult. The recovery of sterling was unjustified and premature on purely material considerations.

It is true that as a result of this premature recovery it became technically possible to stabilise sterling at its pre-war parity, irrespective of fundamental conditions. In April 1925, when the gold standard was restored, the price level in Great Britain was still something like 10 per cent above the price level in the United States. Obviously, sterling was grossly over-valued compared with its economic parity. If in spite of this it was decided to return to gold on the basis of the pre-war parity, it was either because the Government expected to be able to deflate sufficiently to restore equilibrium or because it hoped that equilibrium would be restored through a rise in world prices. The futility of both anticipations eventually became evident. The coal strike and the general strike of 1926 soon put an end to the hopes of bringing about the adjustment through reducing prices and costs in Great Britain. As for the hopes of a rise in world prices, it took several years for their futility to become evident. By looking back we are now in a position to see that it was hopeless from the very outset. Some of the countries were deflating in order to restore their parities with the dollar, while the rest were stabilising their

currencies at an under-valued level, which again tended to produce a deflationary effect upon world prices. In the circumstances, it was hopeless to expect a rise in world prices, especially as in the meantime technical progress had increased considerably the world's capacity of production.

(5) Following the British Example

In adopting the policy of restoring sterling to its pre-war parity, Great Britain set an example which was followed by a large number of countries. In the first place, the British Dominions almost automatically followed the policy of the mother country. The European neutral countries, with the exception of Spain, also adopted an identical policy. One of them, Sweden, was able to attain the end even before Great Britain was able to restore sterling to its pre-war parity. Others took some time after 1925 to return to pre-war parity owing to the difficulties of deflation. Norway, in particular, suffered a great deal as a result of her deflationary policy. In Japan, the deflationary efforts required particularly heavy sacrifices, owing to the depreciation of the yen and the rise in commodity prices caused by the great earthquake. By 1927, however, the whole of the deflationary group had attained its end.

All these countries had to suffer to a greater or less extent in order to be able to restore their pre-war parity. Such was the hypnotic influence of these pre-war parities that all the nations submitted to the sacrifices practically without a murmur. It was considered natural that the end was worth almost any sacrifices. Possibly this was due to the assumption that a return to pre-war parity meant a return to happy pre-war conditions. Few people realised that it was not sufficient to restore pre-war parities so long as fundamental conditions were so utterly different from those prevailing before the war.

(6) Moral Aspects of Deflation

Apart from the desire to see the return to pre-war conditions, the deflationary policy of the various countries was also inspired by a strange conception that deflation was something essentially noble and fundamentally moral. This strange principle of financial ethics was probably due to a reaction from the orgy of inflation. Having gone through a period of reckless expenditure, the countries felt, consciously or otherwise, that atonement was necessary in the form of deflationary sufferings. Even in a country like Czechoslovakia, which had no pre-war

parity to go back to, the official monetary policy aimed at a ruthless reduction of prices irrespective of the sacrifices involved.

It is owing to this conception which makes deflation a matter of moral justice that no particular anti-deflationary feeling was aroused in public opinion throughout these years. The orthodox school took good care to propagate the conception that as deflation was an inevitable consequence of inflation, any sufferings and sacrifices caused by the former should be regarded as the inevitable consequence of the latter. It did not occur to most people that given the fact of inevitable inflation during the war, it would have been possible to avoid the evils of deflation by stabilising at the level to which the currencies were brought by inflation. It was taken for granted in countries which did not depart from their pre-war parities to too great a degree that for them stabilisation could only mean a return to the pre-war parities.

(7) Consequences of Deflation

The immediate result of this policy was the prolongation of the period of economic depression that followed the slump. In Great Britain, Japan and the Scandinavian states, especially Norway, and to a less extent in Holland and Switzerland, unemployment remained at a comparatively high figure for years after the process was complete. In Great Britain and Australia in particular, where the increased political influence of the wage-earning classes made the reduction of costs practically impossible, it proved to be impossible to bring about the necessary readjustment, and the disequilibrium remained in existence until the crisis. Other countries were more fortunate. In Holland, the prosperity of the colonies brought prosperity to the mother country ; Sweden and Denmark soon recovered from their deflationary depression ; boom and travelling fever brought about an increase of Swiss tourist traffic, and Japan was beginning to feel the competitive power conferred upon her by the low standard of living of her working classes in the field of international competition.

Unfortunately the inconveniences caused by stabilisation through deflation did not come to an end when the act of stabilisation was completed. The policy pursued by the countries concerned created a state of disequilibrium which remained in force even though in some countries it was not too much in evidence. The difference in the way in which various countries arrived at stabilisation definitely divided the world

into "cheap" countries and "dear" countries, and this division remained in force until the advent of the crisis which threw the world into the melting-pot once more. The disequilibrium caused by stabilisation through deflation became further accentuated when the inflationary group of countries stabilised their currencies mostly at an under-valued level. This, however, we propose to discuss in the next chapter.

CHAPTER XV

THROUGH INFLATION TO STABILISATION

(1) Arbitrary Choice of New Parities

The stabilisation of currencies after the period of deflation at their pre-war parities was a leap in the dark. None of those responsible for the decisions were aware of the repercussions of their policy. The same may be said to hold good about the stabilisation of other currencies at rates below their pre-war parities. On the surface it would appear that by choosing a new level instead of returning to the old level, regardless of cost, the countries which pursued that policy stood a better chance of selecting the suitable level. In reality, in most cases, the level chosen was almost as arbitrary as the restoration of the pre-war parities. The fundamental factors which should have governed the decisions were equally ignored.

For one group of countries, at any rate, the choice of the rate of stabilisation was a matter of indifference. In Germany and in Russia, where depreciation attained extreme stages, it mattered little what rate of stabilisation was chosen since money and prices were in any case completely " in the melting-pot ". In the case of Germany the rate was one reichsmark for one billion marks. It might as well have been only half a billion or one and a half billion. There was in any case no contact between the old price level and the new one, for the simple reason that during the most advanced stages of inflation, while prices were raised every minute and varied widely from shop to shop, there was no such thing as a price level. In such circumstances, one level was as good as another. It was impossible to say whether the reichsmark was under-valued or over-valued. The great thing was that stability was at last achieved—a task which appeared to be impossible until it was actually accomplished.

In other countries where inflation did not assume quite the same degree as in Germany and Russia, the rate of stabilisation was chosen as near as possible to the lowest point touched by the depreciated currencies. This was the case in Poland, Austria and Hungary, though the latter for con-

siderations of prestige was anxious to choose a higher rate than Austria.

(2) Various Stabilisation Policies

Practically all other currencies of the inflationary group were stabilised above the lowest point they reached during their period of depreciation. This policy was considered justified because for psychological reasons the exchanges of these countries depreciated to an exaggerated extent, so that at their lowest point they were quite considerably under-valued. The degree to which the currencies were allowed to recover before they were stabilised varied widely. It was probably the smallest in the case of Belgium, and easily the widest in the case of Italy. As a first attempt at stabilising the Belgian franc at 107 to the pound in 1926 failed, the Government considered it advisable to be well on the safe side and stabilised for a second time at 175. For similar considerations, Poland chose her second rate of stabilisation at a considerably under-valued level.

On the other hand, Italy deliberately chose an excessively high level for the lira. It is difficult to understand or explain what induced Signor Mussolini to stabilise the lira at 92 to the pound when it was amply evident that at that level it was over-valued. The popular explanation that he wanted to choose a higher rate than France cannot be accepted, but it is impossible to substitute for it any more acceptable explanation. In 1924, France was inspired by the same monetary policy as Italy was two years later. Had M. Poincaré remained in office after the general election he would undoubtedly have stabilised the franc at an over-valued level. Having caused a spectacular recovery of the franc by "squeezing" bear speculators, he could not have resisted the temptation to stabilise as nearly as possible to the high point to which he raised it. By 1926, however, he realised the wisdom of under-valuing rather than over-valuing the currency. The other countries of the inflationary group also preferred to err on the safe side and chose a level at which the currency was under-valued rather than over-valued.

(3) Advantages of Under-Valuation of Currencies

Apart from the difficulty of ascertaining the level at which the rate of stabilisation corresponded to the economic parities of the currencies, there were other reasons why most countries preferred to under-value rather than over-value their cur-

rencies. During and after the war their gold stocks had been depleted to a large extent, so that it was desirable for them to stabilise at a level at which they stood a chance of replenishing their metallic reserve. They were also anxious to avoid or at any rate mitigate the economic depression that inevitably followed stabilisation. Lastly, they were desirous of securing external markets for their exportable goods by under-valuing their currencies.

There is no reason to suppose that at the time of the stabilisation of these currencies the international repercussions of their under-valuation were realised either by the countries directly concerned or by the countries affected by it. Although it was evident that countries which under-valued their currencies were to enjoy certain advantages, these advantages were regarded as essentially temporary. It was taken for granted that in the course of a comparatively short time, inland prices in the countries with under-valued exchanges would, in any case, adjust themselves to the world level. Those countries which were to pay the price of the advantages obtained by the countries with under-valued currencies made no attempt to dissuade the latter from under-valuing their currencies. In the case of France, it would have been useless to attempt to influence M. Poincaré's policy in this respect as in many other respects. Having stabilised the franc without any external assistance, he would have scorned any foreign attempt to influence his choice of the new parity. In the case of Belgium and other countries which stabilised their currencies with the aid of foreign loans and credits, however, it might have been possible for the lending countries to influence the choice of the new parities as a condition of their assistance. No such attempt was made, however, and the choice of the parities was in every case left to the discretion of the borrowing country. Since it was assumed that the advantages attached to under-valuation were purely temporary, the lending countries did not mind having to put up with the inconveniences which they in turn had to suffer through these acts of under-valuation. Evidently, the world can only learn by experience.

(4) Stabilisation Crises

The stabilisation crisis was inevitable after the cessation of inflation, except in countries where inflation did not attain a very advanced stage and where the currency was stabilised at a considerably under-valued level. Thus, France and Belgium were fortunate enough to escape the stabilisation

crisis completely. In their case, inflation did not attain a sufficiently advanced stage to disorganise their economic system, so that the change brought about by the return to stability was not so fundamental. In the case of countries where inflation reached a more advanced stage, stabilisation necessitated a reasonably thorough readjustment. Their whole systems of production, commerce and banking were built up on the inflationary conditions that had been in existence for years. The stabilisation of the currency deprived many an organisation of its *raison d'être* and compelled others to undergo a radical reconstruction.

The speculative structures which were built up as a result of inflation, and which could only exist in inflationary conditions, either collapsed or had to be liquidated. These voluntary or compulsory liquidations of inflationary creations were a painful process which affected the countries to no slight degree. There was in Germany the liquidation of the gigantic vertical trust built up by Hugo Stinnes. This and other similar combines had to be liquidated after stabilisation before it was possible to hope for economic recovery. In Austria, gradual liquidation was impossible, and a series of combines created during inflation collapsed, inflicting heavy losses upon otherwise well-established banks. Apart from this painful process of readjustment, stabilisation was bound to be followed by economic depression, because of the necessity of restricting currency and credit. It is a time-honoured principle of the orthodox school that the stability of a currency can only be maintained by keeping it scarce. As the distrust caused by inflation did not disappear overnight, it was considered advisable to be extremely cautious and pursue an ultra-orthodox policy rather than risk a second collapse.

(4) Stabilisation Crisis not Inevitable

The depression that followed the stabilisation was particularly severe in the case of Italy, owing to the over-valuation of the lira. The industries that depended upon foreign markets suffered to a particularly high degree. The other extreme was represented by France and Belgium, where stabilisation was followed by a period scarcely less prosperous than the inflationary years. The example of these two countries shows that it is possible to stabilise after a period of inflation without having necessarily to undergo a stabilisation crisis. It is calculated to disprove the contention of deflationists that since inflation cannot go on for ever, it is bound to be followed by a

severe reaction sooner or later. It may, of course, be argued that in the case of France and Belgium the stabilisation crisis arrived several years later in 1931 and 1932. In reality, the crisis of 1931 was inevitable in any case, and even though the under-valuation of the franc played an important part in bringing it about, it would have taken place without that factor some other time or in a slightly different form. In any case, those countries which between 1922 and 1927 underwent a stabilisation crisis were affected none the less by the world crisis, so that France and Belgium were more fortunate since they had only one crisis instead of two.

(5) Under-Valued *v.* Over-Valued Currencies

Practically all countries of the inflationary group stabilised their currencies at an under-valued level. This was bound to aggravate further the situation of the countries which over-valued their currencies for the sake of stabilising them at their pre-war parities. Possibly, if they had realised the consequences of under-valuation, and if they had known at the time of stabilisation that the currencies of the inflationary group would be under-valued, they might have reconsidered their policy. The example of Czechoslovakia misled them, however, into the belief that there was a fair possibility of the currencies of the inflationary group being over-valued. After a period of inflation, with the inevitable consequence of the disorganised conditions in which a new Czechoslovak state was established, the Czechoslovak Government adopted a definitely deflationary policy, and raised the value of the crown to a large extent. It was the first country after the United States to stabilise its currency, and it chose a level at which the crown was distinctly over-valued. It is sometimes suggested that the object of this policy was to ruin the German industrialists in Czechoslovakia, and thus to obtain the control of industrial production for the national capital. However it may be, the example of Czechoslovakia may perhaps have led the countries of the deflationary group into the belief that some of the countries of the inflationary group at any rate, once they succeeded in checking inflation, would embark upon a similar policy. Had that been the case, the currencies of the deflationary group would have been relatively speaking less over-valued, and it would have taken a longer time for the situation to reduce itself *ad absurdum*. Even then, however, the world crisis would have been unavoidable. For instance, it would have been impossible to balance the French budget for

any length of time if the franc had been over-valued instead of being under-valued. Although the disequilibrium between price levels would not have been so pronounced, the fundamental disequilibrium between fictitious wealth and real wealth would have been even larger. This in itself would have made a crisis of first-rate magnitude a mere question of time.

(6) DEFLATIONARY COUNTRIES' ATTITUDE

It is possible, though perhaps not probable, that in the absence of the Czechoslovak example, the countries of the deflationary group would have hesitated before committing themselves to stabilisation at their pre-war parities. Had they realised the consequences of under-valuation, they might possibly have awaited the decision of some of the important countries of the inflationary group. The chances are, however, that even in the absence of the Czechoslovak example, most countries of the deflationary group would have acted exactly as they did in the actual circumstances. Only if some country of first-rate importance with depreciated currency had stabilised at a distinctly and deliberately undervalued level would some of the countries of the deflationary group probably have taken the warning, and changed their policy. It is true that by 1925, when most countries of the deflationary group committed themselves to stabilisation at their pre-war parities, some of the countries of the extreme inflationary group had already stabilised their currencies, but in their case the degree of inflation was so much advanced that their choice of the rate of stabilisation could not influence the decisions of the deflationary group. It was only the attitude of the countries where inflation remained within moderate limits that might conceivably have influenced their policy, had it been known at the time they took their decisions.

The author's opinion regarding the choice of the rate of stabilisation by various countries has undergone a fundamental change in the light of the experiences of the last few years. His original view was that the under-valuation of the French, Belgian, etc., currencies was the main cause of the world economic crisis. He now believes that it was not the undervaluation of these currencies but the over-valuation of other currencies which was responsible for the crisis. The level at which France and Belgium stabilised their currencies was probably the correct one. Had other countries followed a similar policy, the disequilibrium inherited from the war would have become reduced considerably. The discrepancy between

price levels would have been levelled out to a large extent, and the disequilibrium between real wealth and fictitious wealth would have adjusted itself. The deflationary movement responsible for the world crisis might have been avoided, or at any rate its proportions need not have exceeded those of an ordinary cyclic crisis.

Thus, while it is technically correct to say that the under-valuation of the franc was one of the direct causes of the crisis, it must be admitted that the fault lies not with the French Government but with those Governments which deliberately over-valued their currencies. This admission is not, however, equivalent to exonerating the French authorities from all blame for the crisis. While they were right in under-valuing the franc, they were wrong in pursuing a policy which prevented the under-valuation of the franc from producing its full effect upon the French price level. The consequences of this policy will be discussed in greater detail in later chapters.

CHAPTER XVI

INTERNATIONAL CO-OPERATION

(1) Need for Co-operation

The deflationary monetary policy pursued by a number of important countries resulted in an unnatural state of affairs which sooner or later was bound to lead to a crisis of first-rate magnitude. It took, however, a number of years before the inevitable happened. The reason for this delay was largely the policy of international financial co-operation adopted by the leading nations. Before the war, international co-operation in the sphere of finance under the auspices of Governments or Central Banks was practically non-existent. On rare occasions the authorities of one country came to the rescue of some other country, but these cases were the exception and not the rule. During the war, close financial co-operation was established between the Allied nations, but it ceased almost immediately after the Armistice. It was revived, however, some years later. At the Brussels and Genoa Conferences resolutions were passed urging close international financial collaboration. The League of Nations provided an excellent medium through which collaboration could be effected.

There was indeed much more reason for enlisting the support of Governments in international financial transactions than before the war. In pre-war days it was possible for almost every civilised country to raise external loans, though sometimes the terms on which they were raised were comparatively onerous. In post-war conditions, however, it was utterly impossible for most countries to borrow abroad in the ordinary course. As a result of the war and post-war conditions, a number of debtor countries defaulted. Investors in Russian, Turkish, Austrian, Hungarian, Bulgarian, etc., bonds either lost their capital altogether or had to accept a meagre settlement. The investing public of the creditor countries lost milliards in consequence, and it is not surprising that there was no demand for fresh foreign bonds during the first post-war years. In any case, those countries which needed foreign loans the most urgently were far from being creditworthy. Their

budgets were unbalanced, and lenders would not have had any assurance that their loans would improve conditions sufficiently to secure the payment of the debt service. In the circumstances, international lending through the normal channels was hardly possible. The loans arranged for some countries such as Czechoslovakia and Jugoslavia were very expensive, and most other countries were not in a position to raise funds, even if they were prepared to pay a usurious rate of interest.

It is customary to regard international co-operation introduced after the war as consisting merely of providing funds for those countries which needed them the most. In reality, co-operation went much further than merely raising loans under the auspices of foreign governments, Central Banks or the League of Nations. It also provided the means for securing the highest degree of benefit to the borrowing countries by compelling them to place their finances on a sounder basis. The loan operations were usually connected with a certain degree of control over the finances of the borrower. Although this foreign control was regarded by the borrowers as a necessary evil, in reality it often helped them more than the loans themselves. It enabled the Governments to introduce unpopular measures without which they would have been unable to regain control over their currencies.

(2) Reconstruction in Central Europe

The first practical result of international co-operation was the reconstruction of Austria. In this case, co-operation assumed the form of arranging an international loan under the guarantee of a number of foreign governments. At the same time, the Bank of England granted assistance directly and indirectly. Throughout the period of financial reconstruction the Bank of England played a prominent part, the importance of which should not be under-estimated. Although in most cases it was the League Finance Committee that arranged the international loans, its work was largely inspired by the Bank of England. The latter also granted advances on the reconstruction loans which were under negotiation. As it took several months for a reconstruction scheme to go through the various stages, these advances enabled the borrowing countries to stabilise their currencies provisionally, before the issues were actually made. The Bank of England together with other Central Banks also assisted the borrowing countries after the issue of the stabilisation loans by means of a stabilisation credit granted to their Central Banks.

The reconstruction of Austria was followed by that of Hungary. In the case of the latter, the loan was issued under the auspices of the League of Nations, without any guarantees of other Governments. The next transaction in which international co-operation played an important part was the German reconstruction. In this case, the stabilisation of the currency was achieved without any external assistance, but the stability of the newly created reichsmark could not have been maintained without the international arrangements made on the basis of the Dawes Scheme. Apart from providing Germany with substantial resources through the issue of the Dawes Loan, this scheme regulated reparation payments in such a way as to prevent transfers interfering with the stability of the exchange. The Bank of England played a leading part in the issue of the Dawes Loan. A number of other countries also benefited by the international co-operation. Bulgaria, Greece, the Free City of Danzig and Estonia obtained loans under the auspices of the League, enabling them to stabilise their currencies and to solve their most urgent financial problems.

(3) Temporary or Permanent Results

In the perspective of history the significance of this movement of international co-operation appears much smaller than it did at the time when it took place. It is now evident that the results achieved were purely temporary. Austria, which was the first country to be reconstructed through international co-operation, was also the first to collapse under the pressure of the economic crisis. Hungary and Germany fared hardly better; these countries, as well as Bulgaria and Greece, ended by defaulting on the loans which assisted them to stabilise their currencies. Only the two smallest beneficiaries of international co-operation succeeded in deriving lasting advantages from the support received. Estonia and Danzig maintained the stability of their currencies and avoided defaulting on their loans.

Generally speaking, however, it may be said that the balance sheet of international co-operation shows little lasting result. In the case of Austria, the loan granted under the auspices of the guarantor states and various other foreign loans and credits raised during subsequent years only served the purpose of bolstering up an essentially unsound and, in the long run, untenable situation. In Hungary, the initial success of reconstruction led to excessive confidence on the part of the lenders,

and the country had to suffer subsequently the consequences of over-borrowing. The same result was obtained in Germany, only on an infinitely larger scale. We shall see in the next chapter how excessive confidence led to foreign borrowing on an unprecedented scale between 1924 and 1929, and how this foreign borrowing became one of the most important immediate causes of the crisis.

(4) A Welcome Respite

It is easy to be wise after the event, and it would be unfair to blame those responsible for the reconstruction of these countries for the ultimate failure of their efforts. They were not in a position to realise that, until the fundamental disequilibrium caused by the excessive increase of fictitious capital had been readjusted to some degree, it was premature to reconstruct and stabilise, that all their efforts were doomed to failure under the inexorable pressure caused by this disequilibrium. In any case, even if the ultimate result of their work was negative, it provided a very welcome respite which enabled the world to recover sufficiently to face the subsequent crisis.

Undoubtedly it would have been better if the post-war statesmen had realised the necessity of scaling down fictitious wealth by the choice of appropriate rates of stabilisation, instead of attempting to bolster up a situation which had no adequate stable foundations. But, given the fact that they did not possess the vision to enable them to arrive at the right solution, the next best thing to do was to create provisional stability in the countries which needed it the most.

It is conceivable that, but for the breathing space obtained by Central Europe thanks to the assistance received through international co-operation, there would have been a complete collapse, and chaotic conditions in that part of the world might have led to the overthrow of the existing social system. Bearing this in mind, it would be ungrateful to those responsible for bringing about international co-operation to lay too much stress upon the ultimate futility of their work without crediting them with the provisional results.

International co-operation was not confined to granting financial assistance to weak countries. Its main object was to enable a number of stronger countries to stabilise their exchanges on a gold basis. Thus, Central Bank credits were arranged for countries such as Belgium and Italy, and even Great Britain obtained large credits for stabilisation purposes

from the United States monetary authorities. Most of these credits were never drawn upon, but the fact that they had been granted was none the less an effective means of facilitating the return of various countries to the gold standard.

Here again it is easy to be wise after the event by saying that since the return to the gold standard at the parities chosen by various countries was a mistake, the efforts to assist them in this task and to enable them to maintain their currencies at their uneconomic parities were futile. Given the fact that Governments concerned did not possess the foresight to choose the right parities, they were only consistent in helping each other to maintain whatever parities they did choose. It is difficult to express an opinion as to what would have happened if, in the absence of international co-operation, most countries had not been able to stabilise their currencies at all. On the whole, the author is inclined to believe that a temporary spell of stability was beneficial, even though it proved to be untenable in the long run. Where the monetary authorities went wrong was that even after the disadvantages of their choice of the rate of stability became evident they continued to cling to it with a tenacity worthy of a better cause.

(5) Closer Contact between Central Banks

In addition to special assistance in the form of loans and credits, international co-operation also assumed the form of establishing close contact between Central Banks. This was essentially a post-war development, and its object was to attempt to establish some form of co-ordination between the monetary policies of the leading countries. This object, like that of the efforts to reconstruct financially weak countries, was, in itself, highly commendable. It was, however, doomed to failure because of the existence of fundamental disequilibrium which placed co-operation between Central Banks under an unduly severe test. In comparatively noımal conditions, it would have been easy for Central Banks to co-operate. As, however, in the existing circumstances, the object of co-operation was to bolster up the state of disequilibrium, the task became extremely difficult.

There was, moreover, a fundamental difference between the monetary policies which the three leading countries were desirous of pursuing. The aim of the United States was to maintain stability of prices as far as possible. The British authorities, on the other hand, wanted a rise in the world prices of commodities in order to restore equilibrium between British

prices and world prices. The French monetary authorities aimed at maintaining the existing disequilibrium between French commodity prices and world commodity prices, since it was in favour of France. Given the fact of this conflict between the monetary policies of the three nations, it was indeed difficult to expect them to co-operate in harmony. The utmost that could possibly be expected was the reduction to a minimum of the frictions caused by differences in monetary policies.

(6) Technical Collaboration

One of the results of co-operation within Central Banks was the undertaking not to withdraw gold from each other without the consent of the Central Bank whose gold reserve was thereby diminished. Purchases by Central Banks in the London market were placed in the hands of the Bank of England which was to co-ordinate their demand. Withdrawals of Central Bank balances were to be carried out in such a way as to cause the least possible disturbance to the markets concerned. There was a regular interchange of information between Central Banks and important decisions, such as bank-rate changes, were usually communicated in advance to the other leading Central Banks.

There were frequent meetings between heads of Central Banks, on which occasions some limited degree of agreement was reached about co-operating in matters of monetary policy. In the technical sphere, co-operation developed to a relatively high degree. For instance, most Central Banks agreed to transfer their foreign exchange reserves to the Central Banks in whose currencies these reserves were kept. We shall see in later chapters that with the establishment of the Bank for International Settlements, an organisation was created to facilitate international co-operation between Central Banks. In normal conditions such achievements would have gone a very long way towards avoiding difficulties. In the existing conditions, however, they did no more than postpone the inevitable crisis.

CHAPTER XVII

THE "GOLD RUSH"

(1) Wholesale Adoption of Gold Standard

The movement towards currency stabilisation, which sought to bolster up the state of disequilibrium that existed after the war, brought to the fore a factor which eventually provided the most important cause of the crisis. This influence was the "gold rush". Originally the term meant the rush of producers to newly discovered gold-fields. In the sense it was used after the war, it meant the rush of buyers to increase their stocks of gold. Given the fact that international co-operation aimed at establishing the gold standard in the largest possible number of countries, it was to no slight extent responsible for this gold rush.

During the war, and during the first few post-war years, the gold reserves of many European countries became to a very large extent depleted. Most of their gold was acquired by the United States and to a less extent by the former neutral countries. The reasonable course to take would have been to wait until an export surplus enabled them gradually to increase their gold reserves, and to postpone the restoration of the gold standard until their position became strong enough. This would have taken, of course, many years, and Europe had no patience to wait. Inconvertible paper currency became discredited to such a degree that every country considered it imperative and urgent to return to gold, no matter how weak its technical position was. Far from discouraging the wholesale restoration of the gold standard, the strong countries actually encouraged it. The demand for gold thus created was all the stronger since many countries were induced to adopt the gold standard who were not on a gold basis even before the war. The League of Nations insisted upon the return to the gold standard as one of the conditions of granting reconstruction loans. It had a serious competitor in this respect in the person of Professor Kemmerer, who was invited by a number of countries in Latin America, Europe and the East to advise them, and who invariably gave the stereotyped advice that they

should establish the gold standard. He gave this advice to every country between China and Peru. While the League of Nations and the movement of co-operation between Central Banks put the best part of Europe on a gold basis, Professor Kemmerer induced the greater part of Latin America to adopt the gold standard. He would gladly have made even China switch over from the white to the yellow metal, little worrying about the fate of the holders of silver, had the difficulties of the Chinese Government in obtaining a large foreign loan not prevented such an absurd step. On the other hand, India and several other Asiatic States actually abandoned silver and adopted gold.

(2) Inadequate Gold Supplies

The result was a considerable increase in the demand for gold. It is true that the supply also increased as a result of the normal accumulation of the annual output, and also of the withdrawal of gold coins from circulation. Owing to the maldistribution of existing supplies, however, and the difficulty of inducing the holders of large gold reserves to part with some of their holdings, the supply available for the Central Banks desirous of increasing their stocks was limited. Admittedly, the deficiency was to some extent made up by the adoption of the gold exchange standard; many Central Banks kept part of their note cover in the form of foreign exchange reserves. Indeed, when the League authorities and the leading Central Banks induced a large number of countries to stabilise, they assumed that most of them would be satisfied with the gold exchange standard. In practice, however, things developed contrary to their anticipations. The system of the gold-exchange standard was never really popular among the Governments and Central Banks, and most of them endeavoured to convert their foreign exchange reserves into gold as soon as possible.

The author is convinced that the inadequate amount of the world's monetary gold stock in face of the increased demand was the most important factor directly responsible for the crisis. Most of those who hold similar views do so on the ground that the existing monetary stock was not sufficient to serve as a basis for an adequate amount of currency and credit. Whether or not this was so will be discussed in a later chapter. The scarcity of gold had, however, another aspect which was not generally realised.

(3) Gold and Fictitious Wealth

The increase in the world's monetary stock of gold after 1914 did not keep pace with the increase in the total volume of fictitious capital. While there is no need for a fixed ratio between the two, it is essential that the amount of monetary gold should keep pace to a reasonable degree with the increase in fictitious capital. It is true that bonds and shares are not convertible into gold, and that there is no need for Central Banks to keep a gold reserve against them. On the other hand, the increase in their amount adds considerably to the extent of international fluctuations against which the Central Banks have to defend their currencies. To give only one example, before the war the amount of British Government securities held by foreigners probably fluctuated between £20 millions and £40 millions. After the war, however, the range of fluctuations was probably something like £50 millions to £400 millions. It would be idle to deny that this increase made it desirable to hold a larger amount of gold stock.

Apart from this, the increase of the volume of fictitious wealth increased the world's requirements of gold in a less obvious way. During the financial crises of pre-war days the amounts involved were relatively small. Governments and Central Banks were in a position effectively to assist their country by granting support to the amount of a few millions of pounds. As a result of the increase of the fictitious wealth after 1914, the figures involved in a crisis are nowadays many times larger than during the crises of the Nineteenth Century. The assistance required is, therefore, also many times larger. Where before the war £10 millions sufficed, hundreds of millions are needed to-day. Such an expansion of credit is not possible under the gold standard unless the reserve is well above normal requirements. This consideration alone would have justified the "hoarding" of gold above the legal minimum requirements, more than any argument ever put forward in defence of the high reserve ratios.

(4) Higher Gold Requirements

The existence of a huge international indebtedness was in itself sufficient to increase monetary gold requirements, especially as a large part of this indebtedness assumed the form of liquid balances shifting from centre to centre. The volume of these floating balances constituted a disturbing factor. It was probably several times larger than before the war, and

holders were much more inclined to change their minds and transfer their funds at a moment's notice than they were in normal conditions. Unsettled conditions in international trade, causing frequent and unexpected fluctuations in trade balances, were yet another factor which tended to increase gold requirements. Moreover, the price level was above its pre-war figure by something like 50 per cent, which in itself accounts for a considerable increase of requirements. Other things being equal, this would have increased the requirements of gold for the purpose of note cover to a corresponding extent. In reality, the increase of the note circulation was, in many countries, well in excess of the ratio of the increase of prices. Thus the cover of the note circulation, on the basis of the pre-war ratio of gold reserve, required a much larger amount of gold than before the war.

The basis of the reserve ratio itself has also changed in such a way as to necessitate more gold. Before the war the legal minimum of gold cover in countries on a gold standard was fixed on the basis of the amount of the note issue. According to a principle that has become increasingly popular since the return of a number of countries to the gold standard, the reserve ratio is now calculated on the figure of the note issue plus sight liabilities. This principle has been embodied in the banking legislation of several countries, and the tendency points towards its general adoption.

An additional factor is the introduction of the gold standard in several countries which were on a silver basis or had an inconvertible paper currency before the war, or in which silver coinage played a restricted part. The decision to establish the gold standard in India was followed by similar decisions in other eastern countries, and even China was playing with the idea of adopting gold instead of silver. The complete demonetisation of silver in countries which formed part of the Latin Monetary Union has increased the gold requirements of those countries.

(5) Demand exceeded Supply

Allowing for all these considerations, it is safe to assume that on balance the demand for gold for monetary purposes has increased to a much greater extent than the amount of the world's monetary supply. Regarded from this point of view, the wisdom of urging a large number of countries to adopt the gold standard was highly questionable. In the course of the Nineteenth Century, the adoption of the gold standard by

most civilised countries was a gradual process. The requirements created were easily met as a result of new gold discoveries which practically coincided with the establishment of the gold standard in many countries. On the other hand, the restoration of the gold standard after the war had been sudden. Within five or six years more countries had adopted the gold standard than during the whole of the Nineteenth Century. Nor was the increase of production sufficient to meet the excess demand which was much more urgent and impatient than at any time in history. As production was practically stationary, and there was little more to be expected from the withdrawal of coins from circulation, the urgent requirements of one country could only be met out of the monetary gold resources of other countries. Thus, the gain of one Central Bank was almost inevitably the loss of some other Central Bank.

(6) Did Gold Rush cause Deflation ?

It is a matter of opinion whether the inadequate amount of the world's monetary gold stock produced a deflationary effect. Probably all that happened was that it prevented the volume of currency and credit from expanding in proportion to the increase in the production of commodities which took place during that period. The fact that the general trend in the world level of prices was declining almost uninterruptedly from the time of the post-war slump seems to indicate that fundamental deflationary influences were at work, but whether or not the gold stock was inadequate for internal requirements, it certainly proved to be inadequate for international requirements. Whether or not there was enough gold in the world to enable countries to maintain an adequate volume of currency and credit, there was certainly not enough gold to cope with the increased international fluctuations.

How far would a drastic devaluation of all currencies after the war have prevented the development of a shortage of gold ? In the first place, the average of commodity prices in terms of gold would have declined all over the world. It may be argued that devaluation is always followed by a corresponding rise in commodity prices. In reality, however, the rise is usually inferior to the extent of the devaluation, unless, of course, devaluation is preceded by a drastic recovery of the exchange, as was the case of Italy. Moreover, while it is only natural that commodity prices should tend to adjust themselves to the new international value of the currency if it is only one country or some countries which devalue, the situation would

be totally different if all countries were to devalue. Had Great Britain, the United States and the rest of the deflationary group of countries devalued in 1920, prices would have risen in terms of the various monetary units, but not nearly to a sufficient extent to cause a rise in terms of gold. If gold prices had remained lower, the volume of gold requirements would also have remained smaller.

Moreover, the reduction of the burden of fictitious wealth through devaluation would have reduced the requirements for gold to no slight extent. The elimination of disequilibrium would have made it possible to stabilise the currencies on a much more solid basis and would, therefore, have reduced the causes for fluctuations requiring a strong gold reserve. It is thus mainly because the deflationary group stabilised its currencies at too high a level that the scarcity of gold developed.

CHAPTER XVIII

THE LENDING FEVER

(1) Lending and "Gold Rush"

It is an irony of fate that the gold rush which was to play such a fateful part in the financial history of recent years was largely the work of those responsible for the movement for international co-operation. It was the reconstruction and stabilisation loans which provided the means enabling various countries to increase their metallic reserves. Moreover, the moral effect of the reconstruction of various countries through international co-operation was to encourage lending to those countries. The granting of a loan under the auspices of the League, or the appointment of a foreign adviser, was regarded in the international financial centres as the hallmark which safeguarded them from losses. The countries concerned were in consequence flooded with offers of loans and credits. A large part of the funds thus borrowed served for the increase of the gold reserves.

To a large extent, international lending during the period 1923–8 concealed the effects of the existing disequilibrium. The loans granted by the United States to Europe helped to maintain an unnatural state of affairs for several years. At the same time, this very process of international lending contributed towards the development of a situation which made the crisis inevitable, and which accentuated the crisis beyond measure once it began.

The false feeling of security and stability created by the stabilisation of a number of currencies stimulated, to no slight extent, international lending. With our knowledge to-day we may find it difficult to understand how the world trusted the appearance of stability, the bases of which were so fragile. It ought to have been obvious that so long as the problem of reparations was not settled satisfactorily, Germany and Central Europe was no safe place for lenders to invest their money. It ought to have been equally obvious that nothing short of a crisis of first-rate magnitude could ever induce France to agree to a scaling down of reparations. Financiers and investors ought to have been aware that such a crisis would not

confine itself to Germany. It was less obvious that there was little or no chance on the basis of the existing monetary policies of eliminating the disequilibrium between various price levels or between fictitious wealth and real wealth. All this was completely overlooked by everybody but a few experts whose warning was disregarded.

(2) Competition between Banks

Competition between various banking centres was also largely responsible for the development of a lending fever. Before the war competition between the principal lending centres, London, Paris and Berlin, was restricted. Each had its *clientèle* and, generally speaking, no efforts were made to poach upon each other's preserves. With the advent of New York as a rival centre, the situation underwent a complete change. In the absence of any previous experience and traditions, the New York banking houses plunged with reckless enthusiasm into international lending. They competed with each other and with the banking houses of other centres for every single loan transaction. It was very easy for any foreign Government, province, or municipality to raise large loans since lenders were cutting each other's throats for the privilege of satisfying the demand for capital. It was said at the time that the leading hotels in Germany had a very prosperous time because most of their rooms were taken by representatives of American financial houses who came to Germany to persuade some obscure municipality to accept a large loan. While Germany was the favourite hunting-ground, other countries also had a due share of this lending fever. Huge amounts were lent to some continental countries and to every country of Latin America. Loans were granted to provinces whose very existence was unknown until their names appeared on the prospectus. Every device of supreme salesmanship was made use of in order to place foreign bonds with an ignorant and indiscriminate investing public.

Although American banks held the lead in this competition, they were by no means alone to blame for the excessive lending. London also had her due share, which was rather more than Great Britain could afford to lend abroad. While the amounts lent by the United States were well within the limits of the surplus available for lending abroad, this was hardly the case of Great Britain. Having acted as the world's leading banking centre from time immemorial, London was reluctant to relinquish its rôle without a fight. Encouraged by the unduly

optimistic official figures of balance of payments, the city was generous in granting foreign loans, not only to old clients but also to newcomers. The result was heavy over-lending throughout the period of stability, which added to the causes of the pressure on sterling. From time to time, the authorities sought to moderate over-lending by introducing an embargo on foreign loans, but this was circumvented to a large extent by placing loans privately or by granting short-term credits. Simultaneously with the granting of loans to overseas countries, there was an accumulation of foreign short-term claims on London which provided the resources for long-term lending. London's position was thus becoming increasingly vulnerable. The same may be said to have been true about Switzerland, though in her case the authorities were at any rate careful enough to accumulate an adequate metallic reserve. Amsterdam and Stockholm also had their due share in international lending. Paris came in after the stabilisation of the franc, though not nearly to an extent comparable with the activities of other financial centres.

(3) Borrowers' Attitude

The attitude of debtor countries in face of this lending fever was exactly what was to be expected. It ought to have been obvious to them that an increase of their international indebtedness would render their position vulnerable. In particular, they ought to have realised the dangers of raising short-term credits abroad, and reinvesting the funds in an illiquid form. But considering the eagerness with which the creditors were prepared to part with their money, it would have been indeed too much to expect the debtors to resist the temptation that was placed in their way. Only very few of them were strong enough to resist the temptation. In Italy, for instance, Signor Mussolini placed a ban on loans issued abroad, and the extent to which Italy participated as a borrower in the orgy of international lending was moderate. In Germany, Dr. Schacht, President of the Reichsbank, made desperate efforts to stem the tide. An organisation was set up to control borrowing abroad, but it was unable to resist pressure on the part of both borrowers and lenders.

Admittedly, to a very large extent, German borrowing abroad served the purpose of enabling Germany to transfer reparations payments. This is, however, no justification for the keenness with which she accepted the loans offered to her. On the contrary, the right policy would have been from the very out-

set to prevent any borrowing abroad, so as to reduce the Dawes scheme *ad absurdum*. Had there not been a flood of foreign loans, the Dawes scheme would have broken down within twelve months of its conclusion. France would have been compelled to face realities and reduce her reparation claim. Instead, the Dawes scheme was kept alive with the aid of borrowing abroad. It was admittedly difficult to resist the temptation since the depreciation of the mark practically wiped out all fictitious capital required for the normal working of the economic system. Where the German authorities were to blame was in that they did not attempt to divert the flood of foreign capital into productive channels. A large part of the amounts borrowed was spent on the construction of municipal swimming-baths and similar investments, which, while increasing the national wealth, certainly did not increase the nation's capacity to pay its foreign debt.

(4) Priority of Commercial Debts

The German authorities have subsequently taken up the attitude that the loans were "forced upon them" to enable them to pay reparations, and that the commercial debts thus contracted are in reality nothing but commercialised reparation debts. This attitude is entirely unjustified. It takes two parties to conclude a loan. The acceptance of the loans offered by foreign lenders was a purely voluntary act on the part of Germany. This, however, does not mean that lenders are not to blame to a large extent for the situation that has arisen. As we said above, they ought to have realised that so long as the problem of reparations was not settled, it was not safe to lend to Germany.

The banking houses engaged in issuing German loans did not even take the trouble to ascertain whether these loans enjoyed priority over reparations claims. Had this question been raised immediately after the inauguration of the Dawes scheme, France and the other interested parties would undoubtedly have agreed that commercial lending should enjoy absolute priority over political debts, for it was only through commercial lending that France was able to obtain large payments between 1924 and 1931. The banking houses all over the world were, however, too anxious to compete for the loans to waste any time and effort on taking such elementary measures of precaution. When the author of this book insisted on the necessity of ascertaining the priority of commercial debts in the columns of the *Financial News* in 1927, he made himself thoroughly unpopular in international banking circles. Even the

authorities preferred to leave the question of priority vague, since it suited their purpose to put off the evil day of reckoning by enabling Germany to pay reparations for the time being out of the proceeds of commercial loans.

The result of the lending fever was that most borrowing countries borrowed far too much, and imported far too much. Had the authorities of the debtor countries declined to accept the proceeds of the loans in the form of an import surplus, the result would have been an accumulation of their metallic reserve. To that extent, the gold rush would have been even more pronounced than it actually was. On the other hand, such a policy would have limited the volume of international lending and the position of debtors and creditors would not have become vulnerable. As it was, the borrowers spent the greater part of their loans on imported goods, so that when it came to the repayment of the loan they did not possess adequate resources to meet their liabilities. This circumstance was particularly important as far as short-term credits were concerned.

(5) Short-Term Credits

In addition to the flood of international long-term loans, there was also a flood of international short-term credits. Before the war London was practically the only centre which specialised in acceptance credits. After the war, however, New York, determined to become the world's leading banking centre, began to grant acceptance credits on a large scale. In addition, secondary acceptance markets were created in Holland, Switzerland and Sweden. After the stabilisation of the franc, Paris also began to take an interest in this line of business. There was, at the same time, sharp competition between banking houses which specialised in this loan before the war, and commercial banks which took up acceptance business during and after the war. As a result of keen competition, the volume of acceptance credits granted rose to proportions far in excess of its pre-war figures.

What is more, acceptance business no longer followed the conservative principles upon which it was based in pre-war days. Only a small portion of it was used for financing genuine self-liquidating commercial transactions. Most of the acceptance credits granted were used for financing long-term transactions. This was the case especially in Germany, where a large part of the funds raised through acceptance credits abroad was used for financing exports to Russia payments for which were not due or some years. This practice was far more

dangerous than the excessive borrowing in the form of long-term loans. High interest rates prevailing in Germany and other continental countries also attracted large foreign deposits which increased the amount of foreign indebtedness subject to withdrawal at short notice.

(6) Risk Ignored

It was amazing how those specialising in international financial affairs were unaware of the dangers of the situation. Even though there were no figures available to indicate the extent of international short-term indebtedness, it was evidently excessive. Even amidst normal conditions, it would have been risky to increase the volume of international short-term indebtedness to such an extent, especially as the greater part of it was not of a self-liquidating character. It should have been evident that the house of cards built up with the aid of this international short-term indebtedness was bound to collapse the moment it received a shock, and that there were ample possibilities for receiving shocks, owing to the unbalanced state of the world.

In addition to the disequilibrium in the economic system which may not have been visible to the man in the street, there was the possibility, indeed the probability, of political shocks as a result of the unsatisfactory state of Franco-German relations. The threatening breakdown of the conference of the Young Committee in 1929 provided a first reminder of the dangers. By then it was, however, already too late. The increase of the short-term indebtedness took place mainly during the latter part of 1928 and in 1929, when, owing to the Wall Street boom, international lending in the form of long-term loans declined. Its place was taken to a large extent by short-term credits, either in the form of an increase of acceptance credits or deposits or in the form of advances on long-term loans to be issued at a later date. By the middle of 1929, it was no longer possible to reduce radically the international short-term indebtedness without administering a severe shock to the international structure.

The freedom with which capital was lent and borrowed camouflaged for several years the existence of fundamental disequilibrium. It should have been evident, however, that this state of affairs would not go on for ever. The increasing extent to which most borrowers and some lenders were becoming vulnerable prepared the way for a huge crisis, the advent of which was a mere question of time.

CHAPTER XIX

FLOATING BALANCES

(1) Growth of Foreign Balances

We pointed out in the last chapter that the increase in the volume of international short-term indebtedness after the war was one of the main direct causes of the crisis. In addition to acceptance credits, deposits and cash advances granted to borrowing countries, there was another type of international indebtedness which also tended to produce disturbing influences. Large floating balances were accumulated in the leading financial centres, especially in London and New York, in the form of current account balances, time deposits, treasury bill and bank bill holdings, and last but by no means least, holdings of Government and other securities. These balances were subject to withdrawal at call or at short notice ; indeed, owing to the existence of facilities for selling the forward exchange the amounts involved were in practice subject to withdrawal at call even if their holders had to give notice or await maturity to collect the actual receipts.

The amount of these floating funds was incomparably larger than before the war. There were several reasons for this increase. During the war, and more especially during the post-war currency chaos, a large number of individuals and firms in the financially weak countries got into the habit of holding balances abroad. Switzerland and Holland were the recipients of large amounts of Central European, French, Italian, etc., refugee funds, known under the popular name of " funk money ". Large amounts found their way also to London and New York. Fear of the depreciation of currencies was by no means the only motive for transferring capital abroad. The increase of direct taxation in countries whose public was not accustomed to be taxed by such methods resulted in wholesale evasion through the transfer of funds to foreign centres. This movement continued long after the stabilisation of currencies restored confidence. Every wealthy Frenchman had at least one account abroad. The extent of the accumulation of such balances abroad is characterised by the fact that

one single French industrial group held in London something like £6 millions to £8 millions during the years preceding the crisis.

Nor were the French the only offenders. Other continental nations pursued the same practice to a greater or less extent, and a large number of finance companies, trust companies, and holding companies were established in Luxembourg, Liechtenstein, and certain cantons of Switzerland, for the purpose of handling the refugee funds. Even English people, in spite of their century-old tradition in direct taxation, began to follow the example after the advent of the Labour Government, which treated taxpayers as enemies, treatment which brought forth retaliation on the latter's part in the form of evasion.

(2) Internationalisation of Finance

The general tendency towards the internationalisation of finance since the war was also largely responsible for the accumulation of floating balances. The number of financial links established between various countries increased considerably after the war. Banks established close relations with banks abroad, whether in the form of affiliations or simply friendly relations. The development of international business by the large joint stock banks in London and New York which before the war confined themselves mainly to internal banking, was one of the causes of the increase of banking deposits abroad. In addition, the habit of investing and speculating in foreign stock exchanges had become increasingly popular during the period of post-war stability. We pointed out in an earlier chapter that the amount of foreign capital invested in British Government securities rose at times to hundreds of millions of pounds. Other securities quoted on the London Stock Exchange and on the various continental bourses were also acquired on foreign account to a large and increasing extent.

Above all, Wall Street became an irresistible magnetic force drawing from time to time huge amounts of capital for investment from every part of the world. The increase in the interest and knowledge of conditions abroad was largely responsible for this tendency. In every country insurance companies, investment trusts and other large investors were desirous of taking advantage of the higher yield offered by investment in other countries, and did not hesitate to attempt to acquire securities which had no international market.

It is true that the effect of this development was largely

cancelled out by the repatriation of foreign securities during the war and by the decline in the volume of international stock arbitrage. The latter was, however, confined to professional operators, and the amount involved was relatively moderate. On the other hand, there developed during the years of monetary stability, a wave of international speculation by the general public, the extent of which was entirely without precedent. The upward movement in Wall Street brought about a gambling fever all over the world. As a result of improved facilities through the establishment of a large number of firms catering for those desirous of gambling in Wall Street, the amount of foreign funds attracted to New York ran into milliards of dollars. In addition to the funds that were transferred to New York to speculate in stocks, Wall Street attracted very large amounts through the high interest rates on loans to brokers. Banks and others who did not care to gamble themselves were induced by the high call-money rate in New York to finance the gambling activities of others.

The movement of these various types of floating balances provided a strong disturbing factor. Though to a large extent their movements were regulated by differences in interest rates, other factors, such as Stock Exchange tendencies, also played a leading part. The shifting of these funds from centre to centre often proved embarrassing for the country whence they departed, and it also caused an *embarras de richesses* to countries whither they arrived.

(3) Central Banks' Foreign Balances

In addition to the milliards of privately owned funds wandering from country to country, Governments and Central Banks also accumulated huge floating balances. Already before the war, it was the practice of certain Central Banks to maintain a foreign exchange reserve with the aid of which it was possible to regulate the exchanges without having to import or export gold. After the war, this practice became much more universal and the amount of foreign exchange holdings that constituted the first line of defence of the national currencies increased substantially. The authorities of many countries accumulated large foreign balances either as a result of foreign loans, the proceeds of which were in part left in the lending centre, or through the repatriation of national capital that took flight abroad.

The practice of accumulating official foreign exchange reserves was encouraged by the adoption of the gold exchange

standard in a large number of countries. The statutes of practically all new or reconstructed Central Banks made it possible to include a certain percentage of foreign balances in the metallic reserve. The practice was encouraged by the leading Central Banks in order to moderate the gold rush which would otherwise have become an acute embarrassment. Small countries which stabilised their currencies with the aid of reconstruction loans kept a large proportion of their note cover in foreign exchange holdings instead of gold. Larger countries, such as Germany, Italy and Japan, pursued the same policy. Above all, the French authorities accumulated a fantastic amount of foreign balances, partly as a result of repatriation of French capital after the stabilisation of the franc, and partly through the favourable trade balance brought about by the under-valuation of the franc. The amount of sterling and dollar balances held by the French Treasury and the Bank of France was for years over £200 millions. This amount constituted a factor of first-rate importance in the sphere of international finance.

(4) Effect of Gold Exchange Standard

There has been a great deal of controversy over the effect of these officially controlled balances upon the international monetary situation. According to one school of thought, the extensive application of the gold exchange standard during the period of monetary stability produced inflationary effects and was the main cause of the speculative boom, which brought about a collapse. There can be no doubt that in theory the operation of the gold exchange standard tends to cause an international duplication of credit, since the same amount serves as a basis for currency or credit expansion in two countries. In practice, however, the extent to which duplication actually took place was comparatively limited, for the simple reason that few Central Banks availed themselves of their right to issue notes on the basis of foreign exchange reserves to any noteworthy extent. In the majority of cases, the whole of the legal minimum reserve ratio was represented by gold holdings, and it was only the safety margin above the legal minimum that consisted of foreign exchange holdings.

In the case of France, the large foreign-exchange reserve of the Central Bank was not allowed to be included in the reserve ratio, and the proportion of the gold reserve alone was always well above the legal minimum. It was only in a few secondary Central Banks that the legal note cover actually consisted

partly of foreign balances, and even these countries gradually replaced those balances by gold. In the circumstances, it is absurd to talk about inflationary duplication of credit on a large scale. All that happened was that the operation of the gold exchange standard reduced the extent to which gold was sterilised by countries who possessed reserves well in excess of the legal minimum requirements. It was only this excess which consisted partly of foreign exchanges.

(5) Moderating the Fall of Prices

Without the operation of the gold exchange standard, the deflationary effect of the gold shortage would have been even more pronounced. Had all Central Banks converted into gold any reserve they could lay hands on, the result would have been a wild scramble, and some of the Central Banks would have lost a considerable amount of gold. They would have had to restrict credit in consequence, thereby accentuating the process of deflation that was going on. Quite conceivably in the absence of the practice of maintaining foreign exchange reserves, the gold standard would already have reduced itself *ad absurdum* in 1927 or 1928 instead of 1931.

The fact that the price level was declining most of the time should in itself be sufficient to disprove the theory that the application of the gold exchange standard produced inflation on a large scale. The adherents of this theory argue, however, that the declining trend was due to the increase of production and the decline of the cost of production, and that owing to the inflationary effect of the gold exchange standard, these factors were prevented from producing their full effect upon commodity prices. This brings us to the question whether it is absolutely essential that increasing production and a lowering of the cost of production should lead to a fall in commodity prices. The majority of economists reply to this question in the affirmative. They maintain that the only way in which mankind could benefit by a lowering of the cost of production would be through a reduction in prices. This, however, is by no means necessarily so. An increase in purchasing power through the increase of productive earnings would result in the same effect. It would enable the public to benefit by the lower cost of production.

(6) Lower Costs *v.* Higher Income

It is purely a matter of opinion whether it would be more desirable that a reduction in the cost of production should be

passed on to the consumer in the form of lower prices or higher incomes. Wage earners would benefit in either case. The first alternative benefits creditors, the second benefits debtors. Trade on the whole stands a better chance of prospering if there is a moderate rise in prices, but a decline if it is moderate and gradual is not necessarily harmful, provided that it is caused by genuine reduction in the cost of production. In our view, on balance, the alternative of raising purchasing power rather than reducing prices is to be preferred even to a moderate decline, and most emphatically to a heavy fall of prices. Between 1925 and 1929, the United States Bureau of Labour index number of wholesale prices declined from 148 to 138, while at the same time, the Board of Trade index number of wholesale prices in Great Britain declined from 159 to 137. The fall was heavy enough even in the United States, being an average of about 2½ per cent per annum. It is easy to imagine how much heavier this fall would have been, but for the operation of the gold exchange standard, which to some extent offset it.

In the circumstances nobody but rabid deflationists can possibly regard the effect of the gold exchange standard upon the volume of credit as inflationary. But for the gold exchange standard the world economic crisis would have begun several years earlier. Whether or not this would have been desirable from purely economic considerations, it is certain that from a social and political point of view the breathing space provided by the postponement of the crisis was highly beneficial. It gave mankind a chance to recover from the effects of war and inflation, and to be able to withstand the sufferings inflicted upon it by the inevitable crisis some years later.

(7) Stimulating Over-Lending

While from the point of view of its effect upon the volume of credit the gold exchange standard was decidedly beneficial, from the point of view of international monetary stability its favourable influence is open to question. By enabling the lending countries to re-lend the same amount over and over again, the system was largely responsible for excessive over-lending. The fault was not, however, inherent in the system, but was due to its improper use. This international lending enabled the financially weak countries to stabilise their currencies, but it rendered the position of both lenders and borrowers vulnerable.

Moreover, the accumulation of officially controlled balances was decidedly a dangerous development. While the movements of privately controlled balances can, to some extent, be influenced by the bank rate, the movement of officially controlled balances depends on totally different considerations. The possession of huge foreign balances placed in the hands of the French Government an immense power on the foreign exchange market, and also on the internal money market of the centres where the balances were kept. This aspect of the problem will be dealt with more in detail in the chapter on "Finance and Politics."

CHAPTER XX

THE MALDISTRIBUTION OF GOLD

(1) The Fact of Maldistribution Incontestable

While expert opinion is divided on the question whether there was a shortage of gold during the period preceding the crisis, it is unanimously admitted that there was a maldistribution. Well over half of the world's monetary gold stock was in the hands of the United States and France. A number of other countries, on the other hand, had highly inadequate gold reserves. Even according to pre-war ideas, by which the gold reserve should serve as a backing to the note issue, the reserve ratio of Great Britain and many other countries left much to be desired. In reality, in the conditions prevailing after the war the main object of gold reserves was not to secure the convertibility of notes—which in practice were inconvertible for internal purposes—but for defending the exchange against international influences.

For Great Britain, a gold reserve of £150 millions, in face of floating balances (inclusive of foreign investments) amounting to something like £800 millions, was evidently insufficient. While in the case of smaller countries, the inadequate proportions of the gold reserve were of relatively little consequence from the point of view of developments in world finance, in the case of a leading international financial centre, which is exposed to the effects of international fluctuations, they were bound to lead to a grave situation.

(2) Great Britain's Inadequate Supply

The over-valuation of sterling in 1925 was one of the principal causes of the maldistribution of gold. It effectively prevented the British authorities from accumulating a larger reserve, though it is doubtful whether, even if the trade balance between 1925 and 1931 had been favourable to Great Britain, the gold reserve would have increased materially. The authorities did not realise the necessity for a larger gold reserve. Even the Macmillan Committee recommended an increase of the gold reserve from £150 millions to about £200 millions only. Had a favourable trade balance increased the gold reserve sub-

stantially, foreign lending would have been encouraged on a larger scale and the surplus would soon have disappeared.

The British authorities and the majority of experts did not realise the fundamental change that had taken place in the situation compared with pre-war days. While before the war, a gold reserve of between £30 millions and £40 millions was sufficient to enable the London market to fulfil its function as the world's banking centre, in the changed conditions after the war, it was impossible to work with such narrow margins. This was not adequately realised. While the United States and France were hoarding gold on a large scale, and other countries were hoarding on a smaller scale, the British authorities imagined that a bare minimum would be sufficient for their purposes. They felt very superior to the authorities of those countries who pursued a policy of gold hoarding. The attitude of those countries was denounced as unscientific and primitive, and yet in the long run it was the hoarding countries who proved to be right. A little less hoarding mentality in France, the United States and a number of other countries, and a little more hoarding mentality in Great Britain would have obviated the evil of maldistribution. It is precisely because the actual and potential gold requirements of Great Britain were underestimated by the British authorities that they did not hesitate to stabilise sterling at a grossly over-valued level. Had they attached more importance to accumulating and maintaining a gold reserve in accordance with the increased requirements amidst changed conditions, they would doubtless have hesitated to raise sterling to its pre-war parity.

(3) Did France and the United States Sterilise Gold?

While the fact of the maldistribution of gold is generally admitted, expert opinion is divided about the question of whether it played any part in bringing about the crisis. According to one school of thought—with which the author associates himself—the maldistribution was artificially maintained by the United States and France, through sterilising their surplus. In other words, the two largest holders of gold did not allow their reserves to serve as a basis for an expansion of currency and credit to a sufficient degree to correct the abnormal position. According to another school of thought, the fault lies with Great Britain for the prolonged maldistribution, owing to her unwillingness to deflate to a sufficient degree to attract gold from France and the United States. This school of thought denies that there was any sterilisation of gold either

in the United States or in France. It is contended that the existence of international disequilibrium was due not to the unwillingness of France and the United States to expand credit, but to the unwillingness of Great Britain to restrict credit.

There are few subjects on which so much sophistry has been produced as on this highly controversial question. The apologists of the French and American attitude deny the very fact that gold was sterilised in the United States and in France. But, following the example of the barrister who feels that the denial of the charge is not likely to carry much conviction, they put forward an alternative defence. While they claim that there was an adequate expansion of credit in France and in the United States, in the same breath they also maintain that so long as Great Britain was unwilling to restrict credit, the American and French authorities could hardly have been expected to expand credit without running the risk of inflation.

(4) Degree of Credit Expansion

Let us examine first the original defence. In support of the argument that there was no sterilisation of gold in the United States, it is customary to quote the figures comparing the movements of the gold reserve on the one hand, and loans, discounts, and investments of the commercial banks of the United States on the other, between 1926 and 1929. Admittedly, during that particular period, the expansion of credit was well in excess of that of the gold reserve. If, however, 1929 is compared, not with 1926, but with 1913, the result shown is totally different. Between 1913 and 1929, the gold reserve of the United States increased about four times, while the total volume of credits of the national banks, State banks and private banks increased less than three times. If the expansion of credit exceeded that of the gold reserve between 1926 and 1929, it was because between 1913 and 1926 the expansion was grossly inadequate, and all that happened during the last three years preceding the slump was that the discrepancy became reduced. The tendency of the volume of credit to adjust itself to the increased gold reserve during the post-war boom was artificially checked. If it had been allowed to take its course, commodity prices would have risen to a level at which they would have tended to cause an outflow of gold. The deflationary policy adopted in 1920 brought about the sterilisation of the surplus, and the subsequent recovery from the slump failed to alter this situation materially.

The same argument may be said to hold good regarding

France. While it is easy to prove, as the apologists of the French policy do, that between 1928 and 1931 there was no sterilisation of the newly acquired surplus, a comparison between 1913 and 1931 presents a totally different picture.

(5) Britain Unable to Deflate

Let us now examine the alternative defence put forward by the apologists of the Franco-American policy. They maintain, with somewhat dubious logic, that although neither France nor the United States sterilised their gold surplus, they were perfectly right in sterilising it, owing to the unwillingness of Great Britain to restrict credit. " How could Great Britain have expected France and the United States," they ask indignantly, " to expand credit so long as she herself was unwilling to restrict credit ? " We are, however, entitled to ask them : " But how could they have expected Great Britain to restrict credit, so long as France and the United States were not prepared to expand credit, without running the risk of deflation ? " The British attitude, in any case, was not determined by considerations of monetary policy. By 1926 it was obvious that Great Britain was not in a position to deflate. The increase of the political power of the industrial population ruled out the possibility of wholesale cuts in wages, and public opinion would have revolted against a deliberate increase of unemployment through deflationary credit restrictions. By 1926, the French and American authorities must have been well aware of this fact. It must have been evident to them that the disequilibrium could not be eliminated through deflation by Great Britain, and that consequently the only way in which it could possibly be eliminated would have been expansion of credit by France and the United States to a sufficient degree to raise French and American prices to the level of British prices. By sterilising a large part of their gold supplies both countries prevented this international readjustment. The United States was at least willing to grant support to Great Britain to enable the latter to maintain the pound at par in spite of the existence of disequilibrium. France, on the other hand, was reluctant to grant even such assistance. In the circumstances, it is not difficult to see which party was responsible for the disequilibrium which eventually led to the collapse of the pound.

(6) " Bank-Rate-Plus-Machine-Gun " Monetary Policy

It is, of course, possible to blame Great Britain for her

unwillingness to cut wages, if necessary by ruthless methods of deflation. Those who maintain this view would have liked to see a very high bank rate from 1925 onwards, supplemented by an adequate number of machine-guns to break down any opposition to ruthless reductions in wages. Everybody but these bank-rate-plus-machine-gun economists realised that given the fact of the power of trade unions and of the existence of a system of unemployment relief, it was politically impossible to pursue a drastic deflationary policy. In the case of France and the United States, on the other hand, the decision whether or not they should contribute towards the restoration of international equilibrium rested entirely with the Governments. It was purely a matter of monetary policy.

In fact, in 1927, the American authorities made a belated effort to ease the position of Great Britain by lowering the bank rate and thus provoking an expansion of credit. It was, however, too late, and in the absence of a sympathetic move on the part of France, it was not effective.

Those accusing Great Britain of having failed to restrict credit in accordance with the decline of her gold reserve point out that between 1925 and 1929 bank deposits actually increased, while the amount of the gold reserve slightly declined. It is always easy to pick out a comparatively short period and use its figures in support of an argument, but it may well be asked whether it is reasonable to assume that the conditions existing in 1925 represented a state of equilibrium. To find figures which may safely be assumed to represent a state of equilibrium, we have to go back to 1913. Between that year and 1929 the gold stock of the Bank of England increased from about £35 millions to about £140 millions, an increase of about 300 per cent. On the other hand, the total current, deposit and other accounts of all English banks increased by less than 100 per cent. during the same period. Even if we allow for the increase of the note issue over the total notes and coins in circulation before the war, the difference remains striking. The comparatively slight expansion of deposits between 1925 and 1929 was merely a process of readjustment, and even in 1929 the gold reserve was not used for credit extension to anything like the extent it was used in the normal year of 1913. While the increase of other forms of fictitious wealth was excessive, the increase of liquid capital was relatively small.

In Great Britain, as in France and the United States, there was an expansion of credit between 1925 and 1929. This was, however, the belated consequence of the accumulation of gold

long before 1925. It is only if we compare the figures of 1929 with those of the last pre-war year that we are able to form a clear picture of the relative extent of credit expansion. We then see that the same quantity of gold served both in Great Britain and in France and the United States for a basis of a much smaller volume of credit in 1929 than in 1913.

(7) The "Gold Standard Game"

The rules of the "Gold Standard Game" are that the country which receives gold should allow currency and credit to expand to a corresponding degree, while the country which loses gold should contract currency and credit to a corresponding degree. It is true there was no actual contraction in Great Britain, but as we pointed out above, a policy aiming at contraction was politically impossible. In any case, as is shown by the index number of wholesale prices, deflation was going on to some degree even without any deliberate contraction of credit. On the other hand, in France and in the United States, the ratio of the gold reserve to sight liabilities was allowed to rise to unprecedented figures. It is impossible to get away from this fact. No juggling with figures of credit expansion can alter it. In the absence of a sufficient degree of expansion in France and the United States, it would have been necessary for Great Britain to deflate to a very high degree in order to restore equilibrium. There is no reason whatsoever to assume that had she deflated to a degree corresponding to her loss of gold, France and the United States would have met her half-way by expanding to a degree corresponding to their gain of gold. On the contrary, but for the inability of Great Britain to deflate, France and the United States would probably have adopted a much more prenounced deflationary policy.

The consequence of the maldistribution of gold was that London was unable to fulfil her traditional rôle and was unable to exert a stabilising influence over the world. In fact, her inadequate strength was one of the main causes of instability, and was largely responsible for the financial crises. Those who are inclined to blame Great Britain for having failed to deflate should be reminded that the loss of gold which in their view ought to have been followed by credit restrictions was not due to any actual trade deficit. Although the British trade balance was affected adversely through the over-valuation of the pound, thanks to invisible items it still had a surplus. Where the official British policy is to blame is that it did not realise the weakness of Great Britain's position and did not

prevent lending overseas far beyond the actual surplus available for that purpose. The difference was balanced by an increase in Great Britain's foreign liabilities in the form of floating funds. It was the withdrawal of foreign balances, especially French official balances, which was mainly responsible for the loss of gold, in addition to the transfer of capital to Wall Street. These capital items in the balance of payments could not possibly have been offset by an increase of exports or a reduction of imports through the adoption of a deflationary monetary policy.

(8) Shortage and Maldistribution

During the years that preceded the crisis the question of the maldistribution of gold was subject to heated discussions. Most people admitting the fact of maldistribution, believed that France and the United States had too much gold. In reality, the trouble was that other countries, especially Great Britain, had too little. The fundamental cause of the difficulties was that given the prevailing price level and other causes for increased requirements, the total gold supply of the world was inadequate. A more reasonable distribution of the supply might have mitigated the evil, but the total volume would still have remained insufficient to meet requirements.

The shortage of gold could only adjust itself in two ways, either by a drastic devaluation of all currencies, or by a drastic process of deflation. The first alternative having been rejected by the deflationary group of countries, nature had to take its course and commodity prices had to decline to a level at which the volume of gold was adequate to meet requirements. Had the volume of monetary gold been more evenly distributed, the level at which it ceased to be out of equilibrium with commodity prices would have been much higher. Given the fact of the abnormally large holdings in the United States and France, the price had to decline to a level which more or less corresponded to the gold holding of less favourably placed countries.

While the fall in prices tended to reduce the disequilibrium between gold stocks and commodity prices, at the same time it tended to accentuate the disequilibrium between real wealth and fictitious wealth. Thus, the process could hardly be regarded as a progress towards the restoration of equilibrium. Evidently, the ideal solution would have been to devalue the currencies instead of deflating, since that solution would have reduced the disequilibrium between fictitious wealth and real wealth at the same time as it restored equilibrium between gold supplies and the price level.

CHAPTER XXI

FINANCE AND POLITICS

(1) France and the Crisis

In the foregoing chapters we indicated a number of financial factors tending to disturb the superficial financial stability created through the stabilisation of currencies. We now propose to deal with the influence of the political factor during that critical period. In his earlier books, especially in *Behind the Scenes of International Finance* and in *Finance and Politics*, the author gave a full account of the working of the political factor. He accused French political finance of being mainly responsible for the crisis. In the perspective of history, the relative rôle of this factor now appears to him much smaller than it did at the time. The author now realises that the French attitude was but one of the number of leading factors responsible for the crisis and that the crisis was, in any case, inevitable, owing to the existence of a state of fundamental disequilibrium, brought about by the decision of the deflationary group of countries to stabilise their currencies at the pre-war level. The author also realises that he was wrong in blaming France for having stabilised the franc at too low a level, and that it was, on the contrary, other countries that stabilised their currencies at too high a level. Apart from this, however, the author sees no reason for withdrawing or modifying anything he said on the subject. He still maintains that the way in which France used her financial power for political ends was one of the direct causes of the crisis as it occurred in 1931.

We have seen in the previous chapter that France and the United States had sterilised a large proportion of the surplus gold they had acquired since the war, and that while the United States was prepared to assist Great Britain to minimise the embarrassment caused by this policy, France was not prepared to adopt a similar attitude. Indeed, through the untimely withdrawal of a large part of her balances, she accentuated the embarrassment of Great Britain to no slight extent.

(2) Big French Balances

As a result of the under-valuation of the franc, France had a substantial surplus available for lending abroad between 1927 and 1931. She was, however, unwilling to re-lend the surplus, except on conditions which secured her the maximum of financial, commercial and—last but by no means least—political advantages. The unlent surplus, together with the equivalent of the repatriation of French balances, accumulated abroad in the form of sterling and dollar balances owned by the Bank of France and by the French Treasury. After the legal stabilisation of the franc, a part of these balances had been either repatriated through gold withdrawals, or had been transferred from London to New York. The result was a severe pressure on sterling.

The possession of a huge sterling balance gave the French authorities considerable power over London. The first time they sought to exercise this power was in May and June 1927, when a certain amount of gold was withdrawn from the Bank of England by the Bank of France. This action was taken in order to cause a stringency in the London money market, which would have suited the purposes of the French monetary policy. This deliberate act of interference with the monetary policy of another country caused much indignation, and there is reason to believe that in the negotiations that followed the withdrawals of gold the British authorities hinted at the possibility of having to suspend the gold standard if the gold withdrawals were to continue. However it may be, the French authorities eventually agreed not to withdraw any more gold from the Bank of England, and subsequently they even agreed not to make any direct purchases in the London gold market.

The concession they made was, however, more apparent than real. Once the gold standard was restored, it was always possible to obtain an influx of gold without having to make direct purchases from the Bank of England or from the open market. All that was necessary was to withdraw a certain amount of the sterling balance. In fact, it was sufficient to tighten monetary conditions in Paris by increasing the idle balance of the Treasury and the Caisse Autonome d'Amortissement, to provoke a flow of gold from London to Paris. Owing to the system prevailing in France, these balances were completely sterilised and reduced the liquid resources of the market. As a result of this reduction, the French banks were

compelled to repatriate some of the substantial balances they held in London.

(3) Political Pressure

There is every reason to believe that the French authorities made use of their influence over London in an attempt to obtain political advantages. At that time political relations between London and Paris left much to be desired. Ever since the conclusion of the peace treaty, the British Government endeavoured to induce France to adopt a reasonable attitude in the matter of reparations. In the Balfour Note in 1922, Great Britain declared herself to be prepared to waive her claims on war debts and reparations provided that other countries were prepared to do the same. This proposal was rejected by both France and the United States. The French Government's attitude from the conclusion of the peace treaty until the Lausanne Conference of 1932 was that she was only willing to reduce her reparation claims to the extent to which her own war debts were reduced.

From time to time the British statesmen made desperate efforts to induce her to modify her attitude, but they succeeded only to an inadequate degree. During the Ruhr occupation, relations between Great Britain and France became rather strained, and even though after the adoption of the Dawes Scheme and the conclusion of the Locarno Pact the relations improved, from 1928 onwards when the necessity for a drastic revision of reparations became increasingly obvious, relations became once more unsatisfactory. On the occasion of the various conferences on reparations there were frequent clashes between the British and French representatives, the former insisting upon reasonable terms while the latter opposed rigidly any adequate concessions to Germany.

Whenever there was such disagreement between the British and French Governments, it was instantaneously followed by a depreciation of sterling and heavy withdrawals of gold from London to Paris. Whenever relations became less strained, these withdrawals ceased. To argue that this was sheer coincidence somewhat overtaxes the credulity of all but the unsophisticated. The author has always held the view that the withdrawals of gold were deliberately engineered by the French authorities in order to bring pressure to bear upon the British Government.

The connection between gold movements and political relations between Paris and London became particularly obvious

after the advent of the Labour Government in 1929. Until then, official political relations between the two countries were reasonably friendly, and it was only the unofficial foreign policy of Mr. Montagu Norman that clashed sometimes with French interests. From 1929 onwards, however, the official foreign policy also became distinctly less friendly, mainly owing to the attitude of Lord Snowden, who did not conceal his strong disapproval of French policy. Whenever he made a statement in Parliament or at an international conference which was disliked in Paris, there was immediately an outflow of gold from London.

(4) No Adequate Co-operation

From time to time efforts were made to improve political and financial relations between London and Paris. It was, however, impossible to obtain wholehearted co-operation on the part of the French monetary authorities. Apart altogether from political considerations, their reluctance to collaborate with other centres was also due to a large extent to their ambition to make Paris the world's leading monetary centre. To that end, it was essential that money rates in London should be kept at a higher level than in Paris. This, together with the desire to earn higher interest rates on the substantial French sterling deposits, accounted for the insistence of the French authorities upon high money rates in London.

The ambition to capture the lead in the sphere of international finance was also responsible for the refusal of French banking interests to participate in any international loan transactions unless they headed the international consortium. Efforts were also made to develop in Paris an acceptance market. In themselves, these ambitions were perfectly legitimate, but together with the excessive influence of politics upon finance they effectively prevented a real collaboration. It was hoped that with the conclusion of The Hague Agreement in January 1930 this state of affairs would improve. The Young Plan provided, in fact, a certain amount of reduction of reparations and its adoption removed for the time being one of the principal causes of Franco-British friction.

(5) The Bank for International Settlements

The establishment of the Bank for International Settlements was also calculated to pave the way towards closer international financial co-operation. In fact, the object of the new institution was, in addition to handling reparations

payments, to provide the means for closer intercourse between Central Banks. Unfortunately, the circumstances in which it was established augured badly for its future. French interests refused to agree that the bank should be established in London, and they insisted on playing a leading part in its administration. The bank thus began operation amid an atmosphere of jealousy and dissent. This atmosphere remained throughout the critical period. The monthly Board Meetings at which the governors of the leading European Central Banks met, far from having improved relations, provided an opportunity for crossing swords. The conflicting currents in the management and the board of the bank reduced the possibilities of useful work.

The circumstances in which the issue of the Young Loan was negotiated also provided an additional source of irritation. The French Government would have liked to induce the British Government to issue in London a larger tranche of the Young Loan, part of the proceeds of which would go to France. The British Government rigidly refused, however, to increase the British tranche of the loan above its participation in the receipts. Thereupon followed a period of heavy gold withdrawals on French account, so that the Bank of England lost as much gold as it would have lost if the Treasury had yielded to the French demand.

(6) Selling Pressure on Sterling

Throughout the autumn of 1930, the selling pressure on sterling continued, and owing to the refusal of the Bank of France to accept gold of standard fineness—which was the only kind of gold the Bank of England was in a position to deliver—sterling depreciated for some time beneath gold export point. Although in January 1931 this obstacle to the free movement of gold was removed, and sterling recovered in consequence, the fact that for some time it was under gold export point was largely responsible for the wave of distrust which came about during the summer of the same year. French political finance effectively succeeded in undermining confidence in the stability of sterling. We shall see in a later chapter the part this same factor played in Central Europe during the critical days of June 1931.

Evidently in normal conditions the factor of French political finance would have had little or no scope. It may possibly have had an influence on the destinies of some secondary country, but it could not possibly have produced any spec-

tacular effect upon the world's position. It was because of the existence of a fundamental disequilibrium, of a shortage and maldistribution of gold and of a huge international indebtedness, part of which was in the form of floating balances, that the factor of French political finance was able to play such an important rôle. Those circumstances do not, however, exonerate France from blame for the disastrous results of the policy.

CHAPTER XXII

THE BOOM

(I) Boom and Deflationary Propaganda

In Part I of this book we pointed out that the disastrous results of inflation in Germany and a few other countries provided the camp of deflationists with an inexhaustible supply of ammunition. Whenever they want to oppose a moderate and perfectly legitimate expansion of credit, a reduction of interest rates or the adjustment of an over-valued currency through devaluation, they invariably warn their public that it will share the fate of Germany if it adopts the measure in question. We pointed out that the circumstances in which inflation took place in Germany were such as to make it appear most unlikely that they would recur except as a result of a lost war and its disastrous consequences.

As in the course of the years the argument that every departure from the strict rules of financial orthodoxy would lead to inflationary collapse was beginning to wear thin, deflationists more than welcomed the fresh supply of arguments provided by the speculative boom from 1927 to 1929. Even though its consequences were not nearly as disastrous as those of the currency collapse in Germany in 1923, they were sufficiently grave to serve the purpose of deflationary propaganda. Partly in order to divert attention from the rôle deflation played in bringing about the crisis, and partly to discredit unorthodox policy, diehard economists point out that all the sufferings and sacrifices caused by the crisis have to be ascribed to the reckless inflationary policy pursued during the years that preceded it.

It is not our intention to defend the boom any more than it was our intention to excuse extreme inflation such as was witnessed in Germany after the war. It is necessary, however, to raise the subject from the level of Hyde Park demagogy to which it is being reduced by deflationary propaganda. It is desirable that the experience of the boom should not be used to discourage a monetary policy which, while departing from the antiquated rules laid down in the Nineteenth Century, is in accordance with the interest of progress in

changed conditions. Public opinion should realise that while inflation and boom are dangerous, stubborn adherence to the orthodox rules is not the only way by which mankind can be safeguarded from these dangers.

(2) The New York Bank Rate Reduction of 1927

It is very difficult to trace exactly the beginning of the boom. According to the opinion popularised by orthodox doctrinaires, it originated through the reduction of the New York bank rate in 1927 from 4 to 3½ per cent. Since this reduction was made in order to assist the British authorities in their efforts to maintain the pound on its old parity, the British monetary policy is consequently blamed for the whole boom and the subsequent slump. The fact is that the rise in the New York Stock Exchange, which was the barometer of the boom, began long before this reduction of the bank rate. Between April 1925, when Great Britain returned to the gold standard, and August 1927, when the Federal Reserve Bank of New York reduced its re-discount rate, the index number of security prices rose from 80 to 122, a rise of over 50 per cent. It was not until the beginning of 1929 that a rise of another 50 per cent took place. Thus, the upward movement was barely faster after the reduction of the bank rate than it was before. The index number of British security prices rose by some 15 per cent between April 1925 and August 1927, and it was not until January 1929 that it registered a rise of another 15 per cent compared with August 1927. Thus, neither in London nor in New York was the rise much faster after the bank-rate reduction than it was before that much-criticised act.

Anyone acquainted with the mentality of speculators in general and American speculators in particular would discard without hesitation the theory that it was the reduction of the bank rate by ½ per cent that let loose the cataract of the boom. Convinced as it was of " everlasting prosperity ", the American public would have speculated recklessly on the basis of a 4 per cent bank rate as much as it did in fact on the basis of the lower bank rate. We have seen that at later stages, when the American authorities made an effort to restrict the amount of loans to brokers, all that happened was that interest rates on such loans rose to a fantastic level. There is no reason to believe that the maintenance of a 4 per cent bank rate would have made the slightest difference to the speculative fever during the following two years.

(3) Speculation and Over-Production

Nor is there any reason to assume that the bank-rate reduction influenced to any large extent the increase of indebtedness on their borrowing for agricultural, industrial, etc., purposes. The same over-buoyant optimism that brought about the Wall Street boom also manifested itself in expansion in every sphere of production. In any case, it had only a relatively small share in the over-production that played an important part in bringing about the fall of prices. This aspect of the problem will be examined in detail in the next chapter.

In itself, the act of reducing the New York bank rate was of small importance. On the other hand, the expansion of credit between 1925 and 1929 may have been, to some extent, responsible for the boom. Unquestionably, it would have been possible by a drastic policy of credit restriction to nip the movement in the bud some time in 1926 or 1927, and to bring about the slump two years before it actually took place. The dimensions of the slump would in that case have been much smaller, since it would not have been preceded by the spectacular rise of Stock Exchange prices, in private indebtedness and production between 1927 and 1929. Undoubtedly, the actual suffering inflicted upon mankind by the slump would have been more moderate. It is a mistake to imagine, however, that, had the decline of commodity prices below their pre-war level been gradual instead of violent, the world would have been any happier than it is at present. The burden of indebtedness, public and private, would have been just as unbearable as it is now.

Where the boom went wrong was in that instead of bringing about a rise in commodity prices coupled with an increase of production, it brought about reckless speculation and over-borrowing. While the production of goods increased, fictitious wealth in the form of private indebtedness and share capital increased to a much larger extent. Thus, the boom accentuated the discrepancy between fictitious wealth and real wealth. It may be said that exaggerated borrowing and speculative increase in the price of securities inevitably accompany a boom. This is doubtless true. Under a system of *laissez faire*, speculation is allowed to do its worst, and the weapons with which the Government fights it are either ineffective or destructive to legitimate trade activity. There is, indeed, no happy medium under a liberal economic system

between allowing speculators a free hand, and crushing producers by credit restrictions in order to check speculators.

(4) Various Forms of Boom

The boom manifested itself in a totally different form in various countries. In the United States, its chief characteristics were reckless gambling on the Stock Exchange, a spectacular increase of private indebtedness of every kind, and the diversion of huge amounts of capital from productive to speculative purposes. At the same time, industrial and agricultural production increased as a result of the application of modern efficient methods. In Great Britain, production was stagnant and unemployment remained all the time around one million. The boom manifested itself in the flotation of a large number of obviously unsound companies the shilling deferred shares of which were absorbed by the public with an amazing facility.

In France, the movement hardly exceeded the proportions of normal prosperity. It enabled the country to escape a stabilisation crisis and to maintain its industries fully occupied after the work of the reconstruction of devastated areas had been completed. In Germany, there was a wave of fictitious prosperity based entirely on foreign borrowing, much of which was for essentially unproductive purposes. In Italy, there was no sign of boom; in fact, the country had to struggle against the difficulties caused by the over-valuation of the lira. Excessive borrowing caused boom-like conditions in Central Europe and in South America. It resulted in an increase in the volume of international trade, notwithstanding the higher tariffs introduced by those countries after the war. While there was no rise in commodity prices the movement had all the usual characteristics of a speculative boom. Apart from Italy, Great Britain and a few other countries, the whole world shared the provisional wave of prosperity between 1926 and 1929.

(5) Inadequate Official Intervention

Contrary to what is believed by puritan deflationists, there is nothing inherently wrong in prosperity. Nor is it inevitable that a period of prosperity should be followed by a slump, and a severe depression, provided that it is regulated through economic planning. The degeneration of the wave of prosperity into a reckless boom in many countries was due to the inadequate extent of Government intervention to regulate the

expansion of economic and financial activity. Any Government which is not afraid to interfere with private initiative threatening to cause mischief is in a position to prevent both reckless borrowing for unproductive purposes and unsound promoting activity. A closer supervision of banking activity by the authorities and the establishment of an investment board would go a long way towards achieving the desired end.

As for speculation on Stock Exchanges, it can be maintained within reasonable limits by fixing a maximum limit to the dividends. This may sound an almost revolutionary suggestion, but it ought to be borne in mind that to some extent the rule has already been adopted in law or in practice in many countries, including Great Britain. The Bank of England never pays more than 6 per cent to its stockholders, no matter how large the profits it earns. The dividends of public utility undertakings are limited by law and can only be raised as and when the price charged for the services is reduced. There is no reason why similar rules should not be applied to industrial and commercial undertakings in general, provided that their application is sufficiently elastic to take account of the individual requirements of each type of investment, as well as the changes in conditions. Had some such measures been adopted in 1926 or 1927, they would have prevented the spectacular rise of equities in Wall Street that reduced the yield of many investments to a fraction of 1 per cent. Together with the activities of an investment board and closer control over borrowing in general, such Government intervention would have been more effective in checking the boom than any policy of high bank rate and credit restriction. What is more, the desired result could have been achieved without crippling legitimate productive activity which is inevitable if the authorities seek to check speculation by orthodox methods.

(6) Boom Mentality

In the absence of such intervention, the boom had to take its course. By 1929, speculation in Wall Street attained fantastic dimensions. The United States was seized by a wave of optimism which, in the light of our experience, appears to us unintelligible. It is difficult to understand how highly intelligent experts seriously believed that the boom could go on for ever, how they failed to realise that the position was becoming increasingly dangerous with every rise in equities and with every increase in the volume of fictitious wealth.

But the development of such boom mentality is inevitable under *laissez faire*. Whenever a country is reasonably prosperous for a few years running, speculators will tend to grow increasingly reckless by anticipating the continuation and increase of prosperity. They discount future capital appreciations until the price quoted for equities loses touch completely with realities. There is no reason whatever to suppose that the lesson taught by the last boom will make any difference in this respect. After all, similar lessons were taught by earlier booms and were promptly forgotten when the subsequent depressions came to an end.

There are always a number of unscrupulous speculators and sinister adventurers who take advantage of the boom and exploit the careless optimism of the public. The Ivar Kreugers, Clarence Hatrys, and innumerable other financiers who were thriving during the boom without actually breaking the law or at any rate without having been caught at it, form an inevitable part of the *laissez-faire* system. They are allowed complete freedom of action on the basis of the sacred right to make mischief, unhampered by Government interference within the limits of the law. It is a wonderful system indeed in which a Government is powerless against the activities of these financiers, even though it is aware of their dangerous character, so long as they are not actually caught at violating the law, which may take years. On a smaller scale, petty company promoters and bondsellers are allowed to unload upon the unsuspecting public millions of worthless securities without being unduly disturbed in their work by Government interference. Indeed, it is an admirable system!

There is nothing inherently wrong with prosperity if it manifests itself in a well-planned expansion unaccompanied by a speculative fever. To a large extent, the boom of 1927–9 was merely a natural trend towards the elimination of the discrepancy between fictitious wealth and real wealth created during and after the war. With the aid of economic planning, this result would undoubtedly have been achieved. By preventing an undue increase of fictitious wealth, the Governments would have diverted the boom into constructive and productive channels. Had it resulted in a permanent increase in the volume of real wealth produced with a corresponding increase in fictitious wealth, the fundamental disequilibrium would have become reduced even in the absence of any marked rise in commodity prices. We propose to enlarge upon this question in the next chapter.

CHAPTER XXIII

ECONOMIC FACTORS

(1) Monetary *v.* Economic Causes of the Slump

The scope of this book is confined to the critical examination of financial developments during the past twenty years. It is not directly concerned with general economic developments except in so far as they are related financially to developments as their cause or their effect. It would be futile to try to explain the financial crisis that followed the boom without giving due consideration to the economic background.

According to one school of thought, the world crisis was due exclusively to monetary causes. Some of those who hold this view blame inflation for all that happened, while in the opinion of others it was the absence of an adequate degree of inflation that caused all the trouble. Both extremes agree, however, that the crisis was due to the monetary factor. According to another school of thought, the money factor played a mere secondary part in producing the crisis, which was mainly due to economic causes. The truth lies between the two conceptions. Both monetary and economic factors contributed their due share in bringing about the crisis.

On the money side, there was undoubtedly an expansion, though judging by the tendency of commodity prices, this expansion was not even sufficient to keep pace with the increase of production. This expansion may not have been actually checked by any deliberate deflationary measures taken by the monetary authorities at the end of 1929. But the increase of the British bank rate in 1929 from 4½ per cent to 6½ per cent may well have been regarded as foreshadowing credit restriction on a large scale such as was enforced during the post-war boom in 1920. It was the rise in the British bank rate to 6½ per cent in September 1929 which contributed probably more than any other single factor to provoke the break that occurred in Wall Street a few weeks later. While the Hatry affair may have had something to do with the increase of the bank rate, the latter was primarily the consequence of the loss of gold by the Bank of England, due to the

pressure on sterling caused by the withdrawal of French funds after the clash between M. Chéron and Mr. Snowden at The Hague. But for the scarcity and maldistribution of gold, the Bank of England would have been well in a position to stand the strain of the withdrawals. Thus, it was the scarcity and maldistribution of gold which was responsible for the shock causing the Wall Street collapse.

(2) Was the Slump Unavoidable?

In the view of a number of experts a continued expansion of credit would have saved the world from the slump. It is conceivable that but for the shock administered by the increase of the British bank rate, further expansion of credit might have prolonged the boom. It is, however, unthinkable, that by such means it would have been possible to avoid the crisis. There was too much explosive material accumulating, and sooner or later there was bound to be a spark causing it to explode. If it had not been the British bank rate it would have been something else. There was the excessive indebtedness, internal and international; the shortage and maldistribution of gold; the reckless gambling fever; and above all, the various causes for economic disequilibrium, which, in addition to the financial factors, constituted a profoundly disturbing influence.

A continuous expansion of credit may well prevent a slump, but only under a system of planned economy, where the development of disequilibria is reduced to a minimum. Had the expansion of credit continued under the circumstances, it might have been able to postpone the collapse, but sooner or later the boom was bound to be followed by a slump. In the circumstances in which the boom took place, it tended to accentuate the various disequilibria.

(3) Maldistribution of Purchasing Power

Apart altogether from the financial factors, there was an economic factor of fundamental importance which in itself was bound to lead to a crisis sooner or later. This factor was over-production. The term is used in various senses. In its broadest sense, it would mean production over and above the requirements of mankind. In that sense there can be no over-production for centuries to come. Until all slum dwellers are housed in palaces, and until all reasonable requirements of everybody are satisfied, there is no social over-production possible. There can, however, be over-production in the

commercial sense, if the total volume of production is in excess of actual demand. This can be the result of maldistribution of purchasing power or of any factors causing excessive saving. A maldistribution of purchasing power prevents consumers from satisfying their requirements, and the goods produced remain unsaleable. In theory it is true that the total purchasing power remains unchanged, but the transfer of a large portion of the total from a large number of consumers to a small number of consumers results in a diminution of the active exployment of purchasing power. This fact is not adequately realised. Some economists, being out of touch with practical life, are inclined to be extremely dogmatic on the question of the redistribution of purchasing power.

The case of the fall in the prices of agricultural products is characteristic in this respect. As is well known, during the years preceding the crisis the employment of newly invented machinery in agriculture resulted in a fall in the price of wheat. It displaced many millions of agricultural labourers and reduced the earnings of farmers, big and small. Obviously the purchasing power of hundreds of millions of people all over the world became reduced. This factor must have been largely responsible for the fall in the demand for manufactures, and the agricultural crisis soon developed into a general economic crisis. This theory which seems to be in accordance with common sense is scornfully rejected by economic purists. In their opinion it is absurd to suggest that the fall in wheat prices made any difference to the total purchasing power of the world's consumers as a whole. It is true that hundreds of millions of farmers had less money to spend; but never mind! their poison was somebody else's meat. If wheat was cheaper, the consumers were bound to benefit by it, and if they spent less on wheat, they were able to spend more on other commodities.

Thus, according to this ingenious theory, all that happened was that purchasing power was transferred from the hands of farmers to the hands of non-agricultural consumers. How very simple all this sounds! There is, nevertheless, a snag in it which is overlooked by the ingenious doctrinaires. The snag is the fact that consumers did not benefit by the decline in wheat prices, or, at any rate, they did not benefit to a full extent, and only after considerable delay.

(4) Time-Lag between Wholesale and Retail Prices

There is always a time-lag between the movement of wholesale and retail prices. It takes some time before the benefit

of a decline in the price of wheat reaches the consumer of bread. The discrepancy may remain in existence for several years, until it is removed by a recovery in the wholesale price of wheat before the retail price of bread can adjust itself to the change. The price of the loaf is inelastic. It takes quite a substantial fall in the wholesale price of wheat before it can express itself in a quotable difference in the price of the loaf. There are many middlemen between the wheat growers and the consumers of bread, each one of whom is doing his best to delay the process of adjustment. The result was that the purchasing power of wheat producers was reduced long before the fall in the price of wheat caused an increase in the purchasing power of consumers.

"What does it matter if that is so," would be the reply of economic purists to this argument. "After all, the purchasing power must be somewhere, it does not evaporate. If the consumers do not get it, the middlemen who benefit by the delay in the adjustment of the price of the loaf to the wholesale price of wheat are bound to benefit by it. It is they who get the surplus purchasing power during the transition period." This may well be so, but it means that the purchasing power lost by hundreds of millions of agricultural consumers will not be the gain of hundreds of millions of non-agricultural consumers, but that of a few thousands or perhaps some tens of thousands of merchants, manufacturers and various middlemen. Clearly, this is a case of maldistribution of purchasing power. The loss of purchasing power by the agricultural population is bound to reduce the volume of actual demand to a very large extent. The increase of the purchasing power of a small group of people may cause a certain increase in purchases, but there is every reason to assume that the total volume of these purchases will be smaller than the diminution of purchases by the agricultural population. The majority of those engaged in production probably spend practically the whole of their incomes, so that any reduction in their incomes is bound to cause a corresponding reduction of their purchases. On the other hand, if a small number of merchants make abnormally big profits, the chances are that a very large proportion of the surplus will not be spent but saved. Thus, in addition to causing a change in the trend of requirements (there will be less demand for boots and more demand for champagne) the total demand for goods, irrespective of their nature, will also decline. This is what took place during the years preceding the crisis.

There was over-production owing to the maldistribution of purchasing power. As a result of the decline in the purchasing power of the agricultural population, a decline which was only partly compensated by the increasing purchases of other classes, it was impossible to find markets for the increasing industrial production.

Even if the middlemen who benefit by the discrepancy between wholesale and retail prices during transition periods were to spend every penny of their surplus profits (a most unlikely assumption) the result would be none the less heavy losses to those who formerly catered for the requirements of the producing classes. The effect of redistribution of purchasing power caused by individual over-production is usually ignored by economic purists. They believe that if the volume of earnings is unchanged and if the total is spent, it matters little, from the point of view of the general situation, whether it is A who spends it or B. This conception gives some idea how utterly out of touch they are with realities. They would find it difficult to explain if they were called upon to do so how Lancashire would be compensated for the loss of orders caused by depression among wheat producers, by the mere fact that some manufacturers of luxuries have increased their sales as a result of the increased profits of middlemen. Their answer would probably be that it does not matter if Lancashire cotton goods manufacturers suffer losses so long as somebody else increases his profits to a corresponding extent. From an arithmetical point of view, the total profits remain the same and the total prosperity remains unchanged. In economics, however, changes cannot always be expressed in terms of arithmetic. The fact that A increased his profit to exactly the same extent as the fall of B's profit does not mean that the community in general is as well off as before. B's losses may react upon C, D and E, and eventually even A himself may discover that he cannot remain prosperous when the majority of people are suffering from depression. Over-production in one individual commodity of importance is likely to lead, therefore, to under-consumption in most commodities, and may thus become the cause of a crisis.

(5) Over-Production in Individual Commodities

There was over-production in a number of individual commodities. Wheat was only one of the many commodities, the price of which tended to decline to an abnormally low level even before the crisis. There was over-production in rubber,

coffee, oil, and various metals. The increased use of oil and of hydro-electric power resulted in over-production in coal. The examples could be multiplied. Even if the only result of this over-production had been a fall of the prices of the commodities in question, and a corresponding reduction in the purchasing power of the producing classes concerned, it would have contributed to no slight extent to preparing the ground for the crisis. Over-production in individual commodities, however, affected the volume of purchasing power also in a different way. Many producers of various commodities were reluctant to sell at the lower prices. In some cases, the commodities were in fact entirely unsaleable, except well below net cost. Supplies began to accumulate and to a corresponding extent active purchasing power declined.

Economists of the classical school would argue that it was the artificial restriction schemes, preventing the cost of production from adjusting itself to a price corresponding to supply and demand, that were partly responsible for the crisis. Indeed, their list of commodities which at one time or another were subject to some action of restriction is very impressive. To read the lists compiled with care by *laissez-faire* economists one might almost imagine that the world lived under a regime of general economic restriction before the crisis. This is exactly the impression orthodox economists are desirous of creating in order to divert attention from the fact that the crisis was the result of too much economic freedom.

(6) Freedom *v.* Restriction

If it were possible to compare the number and volume of commodities which were subject to restriction with the number and volume of those whose production and trade was free from any restriction before the crisis, the truth would become apparent. What is the commercial importance of coffee or rubber which were subject to restriction to that of wheat, or coal or the manufactures of every kind which were not subject to restriction ? The suggestion that the crisis was due to the restrictions upon say 3 per cent or perhaps 5 per cent of the total volume of trade, and not to the 95 per cent to 97 per cent which was completely free, is not exactly a compliment to the intelligence of the public to which these economists address themselves.

The accumulation of stocks in various commodities was due not to any measures of restriction but to the freedom of producers to dispose of their products as and when they thought

fit. In some cases, producers organised pools, but even in the absence of such arrangements producers withheld their supplies from the market. In every case, producers preferred to reduce their sales in the hope that by withholding their supplies they would be able to obtain better prices.

The economic disequilibrium thus created existed independently of any disturbing monetary factors. In fact, it is doubtful whether the economic troubles could have been overcome through the elimination of the monetary factors working towards the crisis. While the immediate cause of the slump was to be found in the monetary sphere, and there were monetary factors also among the fundamental causes, it is impossible to ignore the causes originating through the defective system of production and distribution. These defects were largely the result of the absence of economic planning. Over-production in various branches might have been avoided by planning on an international scale. The maldistribution of purchasing power was another factor which could have been remedied to some extent by Government intervention. Thus, as far as economic factors are concerned, the trouble was not too much planning but too little.

CHAPTER XXIV

SUMMARY OF PART II

(1) Two Ways to Stabilisation

We have now arrived at the conclusion of the second period in recent financial history, that of stabilisation. It is true that after the beginning of the Wall Street slump the currencies remained stable for nearly two years. In fact, the stabilisation of the Spanish peseta and one or two minor currencies did not take place until after the Wall Street slump. Technically the period of stabilisation may be said to have continued until September 1931 when Great Britain suspended the gold standard. As, however, the chief characteristic of the period between October 1929 and September 1931 was not the stability of the currencies but the intense deflation, it is more appropriate to regard the former date as the beginning of the period of deflation, which we propose to examine in Part III of this book. Before going further, however, we propose to summarise the events and developments during the period of stabilisation dealt with in the last eleven chapters.

We have seen that the nations arrived at stabilisation in two different ways, either through inflation or through deflation. The inflationary group of countries included practically all the former continental belligerent and most of the Latin-American countries. The deflationary group included Great Britain, the United States, Japan and most of the former neutral European countries. For the deflationary group of countries, the period of inflation came to an end in 1920. They were determined to stabilise their currencies at pre-war parities, and given this fact, had to follow the deflationary movement in the United States. Indeed, they had to deflate further so as to eliminate the discount on their currencies in relation to the dollar. As this group included almost all the countries which are of first-rate importance from a financial point of view, its policy determined the trend of evolution during the next ten years. The result of this policy was that in a large part of the world the fictitious capital created during the war and post-war inflation had been prevented from

declining, and had in fact been increased. This perpetuated the state of fundamental disequilibrium between the value of fictitious capital and that of real wealth which ruled out the possibility of real stability. In the circumstances, the stabilisation of currencies was essentially built on the surface and, in the absence of fundamental conditions of stability, the attempt was bound to fail sooner or later.

(2) Result of Inflation

Nor was the result brought about by the inflationary group any more fortunate from the point of view of fundamental stability. In several countries of this group, inflation attained such an extreme degree as to wipe out completely the fictitious capital necessary for the working of the industrial system. The result was that it became necessary to recreate the capital by borrowing, and domestic capital was replaced by the most undesirable type of fictitious wealth represented by international loans. Moreover, in the case of Germany and other former continental belligerent countries, reparations and inter-allied debts added to the burden of non-political fictitious capital.

In the case of France, the increase of the public debt through reconstruction of devastated areas cancelled out the greater part of the reduction of fictitious wealth brought about through the devaluation of the franc. In the case of Italy, the burden of the fictitious wealth was increased by the deliberate deflation that preceded and succeeded the stabilisation of the lira. Taking the world as a whole, the choice of the rates of stabilisation or the circumstances in which currencies were stabilised perpetuated the increase of the burden of fictitious wealth to a multiple of its pre-war level.

(3) Discrepancy between Price Levels

In addition to this fundamental disequilibrium, there were many other disturbing factors which tended to undermine the newly acquired stability of the currencies. There was, in the first place, the discrepancy between the price levels in various countries. This was the result of the arbitrary choice of the rates of stabilisation without regard to the economic parities and to the possibilities of adjusting the economic parities to the new mint parities. Nearly all the countries of the deflationary group over-valued their currencies, and consequently they had to deflate further after stabilisation in order to be able to restore the equilibrium of their commodity prices with the

world level. In some countries the adjustment took place without particularly great difficulties, but in other countries, such as Great Britain, Norway and Italy, trade had to suffer a great deal through the over-valuation of the currencies. In Great Britain in particular the attempts to cut down costs resulted in grave industrial conflicts which made the difficulties of deflation obvious.

It was hoped that a general rise in world prices would eliminate the discrepancies without necessitating further deflation on the part of the countries with over-valued currencies. At the same time a material rise in commodity prices might have gone a long way towards reducing the real burden of fictitious wealth and restoring equilibrium between fictitious and real wealth. Unfortunately, the trend of world prices moved in the opposite direction. This was in part the result of the increase in the volume of industrial and agricultural production, and of the decline in the cost of production through the application of modern and efficient methods. In addition, the "gold rush", that is the efforts of most countries to increase their gold reserves, also contributed towards the falling trend of prices. The inadequate supply of gold, together with its maldistribution, provided a most important factor which prevented the rise in prices. It is true that, on the other hand, the application of the gold exchange standard resulted in a certain international expansion of credit, since the same gold served as a basis for credit in two countries. This factor was, however, far from sufficient to counteract the influences working towards a lower price level.

It is difficult to understand how the British authorities could possibly build all their hopes upon a substantial rise in world prices. Given the existing volume of monetary gold, such a rise was impossible. Had commodity prices risen substantially, the rise would have increased the requirements for gold to a corresponding degree. As the monetary gold stock was inadequate in any case, such a development would have resulted in an acute shortage of gold, which would inevitably have reversed the trend of world prices before it had attained the desired degree. There was indeed no hope of achieving a substantial and lasting rise in commodity prices otherwise than through the devaluation of a number of major currencies. Given the level at which the various currencies were stabilised, and given the fact that the countries which undervalued their currencies were unwilling to inflate, it was evident that the readjustment of commodity prices between various countries was bound to take place in a downward direction.

(4) Disturbing Factors

In addition to the tendency towards an increase of the fundamental disequilibrium through a fall of prices, there were other disturbing influences in operation. There was, among others, the political factor which prevented whole-hearted co-operation between the monetary authorities of the leading countries. Admittedly, co-operation would merely have bolstered up an untenable state of affairs, since the fundamental disequilibrium was too strong to be offset by surface measures. At the same time, the absence of co-operation exposed the world of finance to unexpected and unnecessary shocks, and accelerated and accentuated the advent of the crisis.

Above all, the increase in the volume of international indebtedness rendered the world particularly vulnerable to the influence of shocks. In particular, the large amount of short-term indebtedness and the huge volume of floating balances shifting from centre to centre created a dangerous situation. To a very large extent, the false feeling of security created by the stabilisation of the currencies resulted in the development of tendencies which in the event brought stabilisation to an end. It was thanks to this false feeling of security that foreign loans were granted on an unprecedented scale and that funds were invested or speculated with in foreign Stock Exchanges. This false feeling of security was probably, at any rate in part, responsible for the degeneration of prosperity into a speculative boom.

(5) Balance Sheet of Stabilisation Period

The balance sheet of the period of stabilisation shows some heavy items on the debit side. Both the decline in commodity prices and the speculative boom brought about a further increase in the burden of fictitious capital. The additional paper wealth assumed largely the form of international indebtedness which again assumed largely the form of short-term indebtedness. In countries with over-valued currencies the productive classes had to make heavy sacrifices for the sake of achieving and maintaining monetary stability for a few years. It is true that during the period of stabilisation real wealth increased, but as during the period of inflation, the increase took place in a haphazard way in the complete absence of planning. It led to over-production which was largely responsible for the slump. Above all, the deceptive appearance of stability created by currency stabilisation brought about a violent speculative boom which was bound to end in collapse.

On the credit side of the balance sheet, there is in the first

place the fact that the stabilisation of the currencies provided mankind with a much-needed breathing space after the war and inflation. The countries which fared particularly badly during the inflationary period had an opportunity to recover some of the savings destroyed by the depreciation of their currencies. Production increased well above its pre-war figures and the standard of living was raised above pre-war level. The importance of this fact cannot be over-estimated. Had the depression of 1929–34 occurred ten years earlier on the same scale, it would have resulted in all probability in the collapse of Western civilisation. As it was, the nations gained sufficient strength during the period of stability to be able to face the subsequent crisis. If in 1931 and 1932 there was less abject poverty and starvation in Vienna or in Berlin than in 1921 and 1922, it was because of the passing recovery they achieved during the period of stability.

It is unfortunate that the same advantages were not obtained without having to pay the price in the form of the disadvantages enumerated on the debit side of the balance sheet of the stabilisation period. The reason for this is twofold. First of all, stabilisation was carried out in a way that did not make due allowance for the fundamental factors that in the long run were bound to determine the success of the efforts to maintain stability. Apart from this, once stability was an accomplished fact, the absence of adequate planning failed to reduce the disturbing factors to a minimum. There was nothing to prevent over-production in various branches of agriculture and industry, nor general over-production in relation to the limited purchasing power available. There was nothing to prevent reckless speculation, unsound promoting activity and the spectacular increase of private indebtedness. With the aid of economic planning, it might have been possible to increase real wealth to a sufficient degree to make the burden of fictitious wealth bearable. In the absence of planning, such a result was out of the question. Even a moderate increase in the creation of real wealth, such as was witnessed between 1925 and 1929, was bound to provoke a speculative boom leading to an increase of fictitious wealth far in excess of the increase of real wealth. The evil of over-speculation forms evidently an integral part of the *laissez faire* system.

(6) A Favourable Result

Taking everything into account, it may be safely asserted that the balance sheet of the stabilisation period closes with a

favourable balance. There was a net increase in the production of real wealth and in productive capacity. Even though this increase led to a crisis, a great part of it survived the slump and continued to form an integral part of the wealth of mankind. Whatever was the fate of the fictitious capital which financed the creation of additional real wealth, the latter remained even if the former disappeared. It is true that in many cases inadequate planning led to the destruction of products which were not marketable. Coffee was burnt in huge quantities in Brazil and the area of cotton growing was deliberately restricted in the United States. The significance of these losses disappears, however, in comparison with the increase of productive capacity. It is of enormous importance to know that mankind is now in a position to double or treble the production of goods, if only the problem of distribution is satisfactorily solved. The discovery of the technical possibility of multiplying wealth and welfare was largely the result of the stabilisation period. This in itself made the experiment of stabilisation worth while.

The experience of the period of stabilisation taught us a most valuable lesson. Between 1925 and 1929 the nations attempted to work out their salvation by stabilising first and hoping for the best that the necessary readjustment for consolidating monetary stability would take place afterwards. The experience has shown that this is a risky procedure. The attempt at stabilisation failed, and the sacrifices made for the sake of stability were wasted. It is to be hoped that on the next occasion when the nations decide to stabilise they will reverse the procedure and make sure first that a reasonable degree of equilibrium exists before the final steps of stabilisation are taken.

Monetary stability is evidently an advantage for the sake of which it is well worth while to make sacrifices. What is important is that the means should not be mistaken for the end. Monetary stability is not the end itself but merely the means by which the ultimate end of progress and prosperity can be achieved. If it does not assist mankind to achieve that end, or if it requires sacrifices which are out of proportion to the extent to which it assists in progress and prosperity, then the statesmen responsible for the management of the world's monetary affairs should not hesitate to sacrifice monetary stability.

PART III
DEFLATION

CHAPTER XXV

WHAT IS DEFLATION?

(1) Rising v. Falling Prices

Generally speaking, under stable monetary conditions there is more chance for progress and prosperity than under rising, falling or fluctuating prices. Under stable monetary conditions speculative risk attached to legitimate trade and investment is reduced considerably; the number of unknown factors is limited, and ability, hard work and honesty have the best chance to win their well-earned reward. Rising, falling or fluctuating prices tend to upset calculations and to increase the difficulties of planning, whether individual or collective. They introduce unknown factors, increase risks and result in undeserved gains and undeserved losses. Stability is, therefore, evidently to be preferred both to inflation and to deflation. The question is, how the two extremes compare with each other. If prices cannot be kept stable, which is the smaller evil, a rising price level or a falling price level?

From a purely practical point of view, a rising price level, provided that the movement is moderate, is decidedly more in accordance with the requirements of progress and prosperity than a falling price level. The rise encourages productive activity, since it increases the prospects of profit for producers and it penalises unproductive capital. Under rising prices there is ample scope for the expansion of production both regarding its extension and its intensity. It becomes profitable to fertilise hitherto unproductive areas; to connect up backward regions with modern means of transport; to improve land and other means of production through capital expenditure; to modernise plants and apply new inventions; to experiment with new methods, whose commercial value is not yet proved; to encourage every kind of improvement, innovation and invention. On the other hand, during a period of falling prices, the exploitation of relatively less profitable means of production has to be abandoned, progress towards expansion is reversed, the risk attached to the application of new methods is increased, invention and innovation requiring capital expenditure is discouraged.

(2) The Apologia of Deflation

Indeed, a falling price level has barely any redeeming features. Ardent deflationists profoundly disagree, however, with this assertion. They maintain that it is under falling prices that efficient organisation is at its best; that under rising prices production is inclined to be wasteful; and that it is exactly under falling prices that the cost of production can be reduced to a minimum. This argument sounds barely convincing. So long as everybody willing to work is not fully employed, it matters little from the point of view of mankind as a whole if the method of production applied is not as economic as it could be made to be under a falling price level. In this respect, it is necessary to discriminate between the individual interests of particular companies and general interests. During a period of depression it is a customary feature of chairmen's annual speeches to boast of the marvellous achievements in the way of cutting down costs. "You will be pleased to learn," the shareholders are told, "that your company is doing as well as can be expected in the existing circumstances. It is true that it made no profit last year, but your directors succeeded in enforcing drastic economies during the past year by dismissing two typists and an office boy." Conceivably, shareholders may derive some slight satisfaction from this fact, but on the other side there is the problem of what is going to happen to those who have become victims of the axe. When every typist and office boy is fully employed, and there is a demand for some more, then the reduction of the number employed by particular enterprises is doubtless beneficial for progress, but so long as there is unemployment, it is difficult to see how progress is served by cutting down further the number of those employed.

It may be objected that the duty of the directors is not to look after the interests of the community as a whole, but to safeguard the interests of the shareholders; that they should not hesitate, therefore, to cut down salaries and cut down the staff to the utmost limit if in doing so they can increase profits or reduce losses. This narrow and selfish attitude is defended by orthodox economists, according to whom anything we do for our own selfish benefit is bound to work out for the benefit of the community. It is on this principle that the whole system of *laissez faire* is founded. There is no need, according to this principle, to worry about the fate of those who become the victims of the economy axe. In the long run their sufferings will be beneficial to progress since the reduction of wages

caused by unemployment would eventually enable employers to increase production.

The glaring fallacy of this argument has become only too painfully evident during the last few years. The reduction of wages brought about by deflation, far from having created additional employment, tended further to depress trade and further to increase unemployment. This aspect of the problem did not, of course, occur to the directors who cheerfully cut down their staff to enforce petty economies. If the directors of any one single company or of a small number of companies had been alone in pursuing this course, their shareholders might have enjoyed the full benefit of the economies without having to put up with its disadvantages. Since, however, the movement had become general, the reduction of purchasing power thus caused aggravated the depression, with the result that the earnings of the companies in question eventually declined to a larger extent than their overhead charges. In the light of this experience, the fundamental principle of *laissez faire* might well be reversed, since it is evident that in the long run it is profitable for individual undertakings to manage their affairs in accordance with public interest.

(3) Moral Considerations

Those who argue in favour of deflation usually invoke moral rather than practical arguments in support of their opinion. They maintain that the only way in which the depreciation of a currency can be prevented is by keeping it scarce, and since a depreciation of the currency would inflict grave injustice on a large section of mankind, deflation is, therefore, the instrument of supreme justice. This argument is, however, untenable for two reasons. First, it cannot be taken for granted that the only way in which the stability of a currency can be maintained is by deflation. On the contrary, given the fact of an increase in production, the only way in which stability of prices can be maintained is by a corresponding expansion of currency and credit. If the volume of credit remains stationary while production expands, the result is not stability but a fall in prices. Conversely, if an expansion in the volume of credit is accompanied by a corresponding increase in production then it need not result in a rise in prices. Since the chances are that production will tend to rise, more often than not it is through expansion of credit and not through restriction that stability can be maintained.

As for the conception that is contrary to principles of

justice that certain classes should be penalised by the depreciation of the monetary unit, it is incontestable. At the same time, it is equally contrary to the principles of justice if certain classes are penalised through the appreciation of the monetary unit. This is what deflationists refuse to admit. They consider it justifiable to cause an appreciation of, say, 40 per cent in the value of the monetary unit in their effort to prevent a depreciation of, say, 20 per cent. And yet there are at least as many people who stand to suffer through an appreciation of the monetary unit as through a depreciation of the monetary unit. Debtors of every kind are the obvious victims of deflation. Producers are less obvious victims, but experience has shown that trade declines and unemployment increases as a result of a falling tendency of prices. If monetary policy is an instrument of supreme justice, it should be opposed to deflation to at least the same extent as to inflation.

(4) Deliberate *v.* Spontaneous Deflation

Deflation, like inflation, can be either engineered by deliberate policy or it can take place spontaneously. There is no rigid line of demarcation between deliberate and spontaneous deflation. As a deliberate policy, deflation is brought about by a reduction in the volume of currency and credit. It can, however, come about by the mere anticipation of credit restrictions as a result of warning given by the monetary authorities, usually in the form of an increase of the bank rate.

The apologists of deflation usually quote figures to prove that there was no sign of any deliberate credit restriction before the slump began. It is true that the extent to which an increase of the bank rate causes actual credit restriction is comparatively limited. On the other hand, it serves as a warning which is usually followed by the banks who begin to call in credits as soon as they notice the danger signal. Thus, there is no need for the Central Bank to take the initiative for restricting credit in order to provoke deflation. Banks themselves will do the work as soon as the Central Bank gives the warning. This is what happened in 1920 and also in 1929.

On many occasions deflation takes place spontaneously in some countries as a result of deliberate deflation in other countries. Very frequently deflation continues long after the official monetary policy ceases to be deliberately deflationary. The depreciation of the currency of a foreign country can also produce deflationary effects abroad if it is not accompanied

by a corresponding rise of commodity prices in the country whose currency depreciates.

(5) Misleading Deflationary Arguments

It is a favourite argument of ardent deflationists that credit restrictions are highly beneficial on the basis of the *laissez faire* principle of " the survival of the fittest ". Apart from defending the currency, credit restrictions also result in the elimination of " weak " and " unsound " positions. Few adherents of deflation have the courage or the honesty to define exactly what they mean by the elimination of unsound positions and what they mean by unsound positions themselves. They talk vaguely about reducing commodity prices by credit restriction, but they do not disclose how the process works. They do not admit that it is a brutal and ruthless method. It consists of compelling producers and merchants to throw their stocks on the market to sell them at a big loss if they can, and to go bankrupt if they cannot. The bankrupt stocks thrown on the market will doubtless force commodity prices down, but at what cost? The reply of the deflationists would be " by eliminating weak and unsound positions ". They convey the impression that the process means the elimination of something that is unnecessary or undesirable; in one word, that the world is better off without the firms which are driven bankrupt through credit restrictions. It is difficult to imagine anything more fundamentally wrong than this conception. The firms which are submerged in the deflationary crisis may or may not be undesirable, but the fact that they submerge does not in the least prove that they are undesirable.

Let us examine what our deflationists mean exactly by the so-called weak and unsound firms, whose disappearance fills their hearts with such joy. Do they mean firms whose activities are of no social utility? Certainly not. To their minds, a dog-racing company or a firm engaged in white slave traffic may be perfectly sound so long as they have enough liquid reserves to weather the crisis. On the other hand, an enterprise engaged in manufacturing surgical appliances is called unsound if it is not in a position to sell suddenly a large quantity of its goods when called upon unexpectedly to repay an overdraft. The appliances it manufactures may save innumerable lives and reduce human suffering, but such circumstances do not prevent deflationists from rubbing their hands with satisfaction when the company closes down. " We are making good progress towards the elimination of weak and unsound positions."

(6) The "Survival of the Cheapest"

Evidently deflationists do not judge soundness of enterprise by its social utility. Do they regard it from a narrower viewpoint, whether or not the enterprise is commercially sound? We doubt it. Very frequently enterprises whose products are normally marketable but which are not in a position to increase their sales suddenly amidst a crisis if called upon to repay their loans, become victims of credit restrictions. Firms which are commercially justifiable, but which have had no chance of accumulating an adequate reserve, are condemned to insolvency under the pressure of deflation. On the other hand, companies whose value as commercial propositions is questionable, but which happen to have sufficiently large liquid reserves, survive the crisis. Needless to say, it is not the firms which try to raise public taste and improve the quality of the goods consumed that stand a chance of surviving the crisis, but firms which cater for the lowest tastes. The result of deflation is "the survival of the cheapest".

To the minds of deflationists the test as to whether a firm is sound or unsound is whether when credit restrictions are applied it happens to have a balance or an overdraft. This conception may be right or may be wrong under the existing system, but readers and audiences of those orthodox economists who talk about the elimination of "weak" and "unsound" positions have the right to know what is meant by those "weak" and "unsound" positions. It is not exactly fair play to obtain approval of a policy under false pretences. Credit restrictions may or may not be indispensable, but those who are asked to approve of deflationary measures have the right to be told about its disadvantages, which have to be compared with its alleged advantages. It is a high degree of intellectual dishonesty to convey—if it is only by implication—the impression that deflation is a process of purging, which is advantageous for its own sake, apart altogether from considerations of monetary policy.

Another important consideration which is overlooked, deliberately or otherwise, by deflationists is that the process of deflation at the same time as eliminating some of the so-called weak positions creates new ones. With every fresh credit restriction, increase of interest rates, or fall in commodity prices a new set of producers or merchants is forced to sell at a heavy loss and many of them become insolvent in consequence. Firms which were perfectly solvent and sound, even

in the narrow sense of the term as understood by orthodox economists, when the index of commodity prices was at 140, become hopelessly bankrupt through the decline of the index to 100. They are evidently the victims of deflation, which fact, however, does not prevent orthodox economists from being delighted by their failure as " yet another step towards the elimination of weak positions ".

(7) Limits of Deflation

Uncontrolled deflation has the same avalanche-like characteristics as uncontrolled inflation. After a number of so-called weak positions are eliminated, the heavy losses thus inflicted upon banks result in a banking crisis, and the closing down of some banks intensifies the deflationary crisis by inflicting heavy losses on depositors and thus creating new weak positions.

The process cannot, however, go on indefinitely. Even if the monetary authorities do not take deliberate reflationary measures to reverse the trend, deflation driven to extremes may reach a point at which it becomes automatically reversed. The depression results in a heavy decline of budgetary revenue, and it is impossible to compress expenditure to the same extent, owing to the rigidity of some items, especially the service of the public debt. Extraordinary calls are also made upon the resources of the Treasury for the support of the unemployed, and for assistance to banks whose failure would produce disastrous results. The public debt will tend to grow and the Treasury will find it increasingly difficult to cover its requirements by normal borrowing. A stage will be reached when inflationary borrowing will be the only alternative to default on the public debt.

It will be seen in the following chapters that in its results deflation can be almost as destructive as extreme inflation. If the suffering inflicted upon mankind by the deflationary crisis that began in 1929 was not as acute as the suffering caused by inflation in Germany and a few other countries, it was largely because conditions had improved considerably during the ten years that separated the two crises. The world's resisting capacity to the crisis, which was at its lowest after the war, had increased beyond comparison by 1929. The same degree of unemployment which in 1919 would have led to wholesale starvation and anarchy was survived without any such catastrophic effect. We have to bear in mind the difference in general conditions when comparing the effects of deflation between 1929 and 1934 with those of inflation after 1919.

CHAPTER XXVI

THE SLUMP

(1) THE RÔLE OF WALL STREET

EVER since 1929 controversy had been raging about the circumstances in which the boom was followed by the most disastrous slump of modern times. According to one view, the Wall Street slump was largely responsible for the depression and the crisis, or, as some prefer to put it, the series of crises that followed it. According to another view, Wall Street merely acted as a highly sensitive barometer, indicating the break in economic prosperity and foreshadowing the coming economic troubles. In our opinion, the truth lies between the two views. Unquestionably the Wall Street slump delivered a blow that shook the economic structure of the United States, and the change for the worse in economic conditions in the world's most important country was bound to react upon the rest of the world. In spite of this, the Wall Street slump would not in itself have produced such spectacular results either in the United States or in other countries but for the fact that the world was extremely vulnerable. In Part II of this book we described the various influences which were working towards the crisis; the Wall Street slump merely played the rôle of the spark which set ablaze the huge volume of inflammable material that had been accumulating. The comparison with the rôle of a barometer is, however, untenable since barometers have never been known to influence the weather to the very slightest degree, while the Wall Street slump was unquestionably the immediate cause of the crisis.

It was evident throughout 1929 that the situation in Wall Street was overripe for the slump. The only question was what would provide the immediate motive for it. The American monetary authorities had been waging a vain struggle against the gambling fever by attempting to discourage lending to Wall Street. The sole result of their efforts was an increase in the rates of interest on brokers' loans to a sufficiently high level to attract the funds Wall Street required. No matter how high money rates rose, it did not discourage gambling, since the rise

on a few days covered the interest for a whole year. The worst of it was that genuine investors were reluctant to sell when speculators drove prices to a fantastic level, owing to the system of taxation in the United States by which capital appreciation is subject to income tax when it is actually obtained through the realisation of the appreciated assets. Thus, investors who desired to sell would have been made to pay huge amounts in income tax. This factor probably delayed the slump, which might otherwise have taken place some time in 1928 or early in 1929.

(2) Developments in Great Britain

There is reason to believe that the immediate cause of the Wall Street slump originated in Great Britain. As a result of the victory of the Labour party at the general election in June 1929, the prospects of British industries were viewed with much pessimism. This in itself was a bull point rather than a bear point for Wall Street, since large amounts of British capital were shifted into American securities. At the same time, it resulted in the collapse of the promoting boom in Great Britain. A number of groups promoted between 1927 and 1929 were considered highly vulnerable in any case, and the Socialist victory accelerated their doom.

The Hatry affair in September 1929 was the first of the long series of painful liquidations. Its circumstances and the magnitude of the amount involved caused a very bad impression in the London market. At the same time, the persistent outflow of gold to Paris and New York induced the Bank of England to raise its rediscount rate to 6½ per cent in September 1929. The combined result of the shock caused by the Hatry affair and the increase of the bank rate was the withdrawal of British funds from Wall Street. Even though the amount of British funds withdrawn was only a small percentage of the total engaged in Wall Street speculation, the shock was sufficient to bring about the long overdue slump.

(3) Effect of Wall Street Slump

The effect of the panic-like selling in October and November 1929 in Wall Street was the rapid development of an acute economic depression in the United States. The wave of prosperity that culminated in 1929 was largely based on the profit made on appreciating stocks, and to a still larger extent by the anticipation of a future increase of earnings. Instalment selling reached a very high degree all over the world

during the years of prosperity, but nowhere was it as advanced as in the United States. On the assumption that earnings would further increase or at any rate would not decline, millions of consumers mortgaged their incomes for years ahead. The uncertainty created by the Wall Street slump checked this buying fever instantaneously. Before long, industrial activity was reduced to a fraction of its productive capacity which had been increased considerably during the wave of prosperity. Unemployment increased and caused a further reduction in purchasing power. The decline of commodity prices became accentuated in 1930, which in itself tended to discourage production and buying. There were a number of failures and it was an open secret that all banks carried huge frozen positions. This created a feeling of uneasiness which was also largely responsible for inducing consumers to limit their purchases to necessities.

In addition, the banks considered it necessary to restrict credits, thereby setting in motion the vicious circle of deflation as described in the last chapter. It cannot be said that the official monetary policy of the United States was deliberately deflationary at this stage. Such deflationary measures as contributed to the depression were taken before and not after the Wall Street slump. It was the banks themselves who considered it advisable to try to safeguard themselves against bad debts caused by the slump by calling in credits, and to increase their liquid resources in case of emergency. Since bad debts soon became frozen, the banks had to call in good debts, thereby compelling in innumerable cases sound and solvent producers to restrict their business activity for lack of credits. All the time, the prices of securities on Wall Street kept on declining; and the banks had to realise after every fall large amounts of securities held against loans, as the margins had run out. Indeed, the United States in 1930 provided a classical example of a country in the grip of acute depression.

(4) Repercussions on Europe

Strangely enough, the first reaction to the crisis in the United States was a feeling of relief in Europe. The Wall Street boom was beginning to cause inconvenience to Europe from 1928 onwards, since it diverted considerable amounts of capital which would otherwise have been lent to Germany and other borrowing countries. In addition, Wall Street attracted considerable funds from Europe itself. It was thought that, since as a result of the slump the European funds would return, and

the American investors after the disappointment in equities would once more turn their attention to foreign bonds, Europe would benefit by the turn in the tide. In reality, the beneficial effects of the Wall Street slump upon Europe were negligible. It is true that the European funds (at any rate, whatever was left over of them after the heavy fall in Wall Street) returned, and this provided a certain amount of relief to Europe. On the other hand, many European holders of American securities who suffered heavy losses got into difficulties. There was no sign of a revival of American lending activity. The Wall Street slump discouraged every kind of financial initiative in the United States, so that lending abroad was not resumed.

Before long, Europe had to realise that she could not remain prosperous if a country of the importance of the United States was in the throes of an economic crisis. The fall in commodity prices did not confine itself to the United States. Before long the whole world was suffering from acute depression. In the manufacturing countries, unemployment was increasing on an alarming scale. In the agricultural countries, the fall in produce prices resulted in a heavy depression. In countries such as Australia or Brazil the crisis attained its climax long before it attained its climax in Europe or in the United States. Great Britain, which had failed to participate in the wave of prosperity except in the form of a highly unsound promoting fever, took her full share in the slump. In Germany, unemployment, which was already high in 1929 as a result of badly planned rationalisation and the cessation of foreign lending, began to assume alarming dimensions during 1930. France was able to resist the economic crisis to a remarkable degree, owing to the under-valuation of the franc, but she did not escape a banking crisis towards the end of 1930, when the Oustric group of banks failed together with a number of other French and colonial banks. There were also bank failures in other countries, especially in the United States, though the movement at that stage did not assume an extent corresponding to the dimensions of the slump.

(5) A Cyclic Crisis

There was a world-wide decline in purchasing power as a result of the slump in raw materials. At the same time consumers all over the world showed less and less willingness to make use of their purchasing power. Although there was no consumers' strike similar to that of 1920–1, consumers were evidently reluctant to buy. Notwithstanding all this, it did

not appear in 1930 as if the crisis would exceed the dimensions of that of 1920–1. The world did not realise that it was on the eve of a financial crisis of unprecedented magnitude. It was generally believed that once the fall in commodities and on the Stock Exchanges had reached a certain degree, things would settle down once more, and after a period of comparative depression, the upward movement would be resumed. Most people did not expect that the crisis would exceed the dimensions of the usual cyclic crises.

Developments early in 1931 appeared to have confirmed this impression. After the turn of the year, there were distinct signs of improvement. Financially, the banking troubles in France, the United States and elsewhere appeared to have come to an end. The adverse pressure on sterling which gave rise to some uneasiness during the second half of 1930 ceased. Economically, there were signs of a moderate improvement in trade, and the world began to regard the situation with a certain amount of guarded optimism. The bank rates which were raised in the leading countries to a high level during the final stages of the boom, were gradually reduced, and the fall in demand for credit accommodation brought about a period of cheap money. This was in accordance with the classical rules followed by cyclic crises, and created the impression that the climax was over and that the trend was once more on the upward grade.

(6) Elements of Instability

Events soon proved that this optimism was entirely unjustified. It may well be argued that but for political and financial developments in Central Europe which were entirely unconnected with the general trend of the crisis, world-wide recovery would have followed on the lines of the recovery that followed the slump of 1920–1. In reality, the situation was totally different from that of ten years before. During the decade that preceded the crisis, there was a large increase in international floating indebtedness which provided an element of instability. The financial structure of Germany and Central Europe was based entirely upon the unstable foundations of floating international indebtedness, and it was evident that sooner or later the house of cards would collapse under a shock. The factor of reparations and inter-allied debts also provided the Damocles' sword. The fall in commodity prices increased the burden of these payments together with those of debts of every kind, while the shrinkage of international trade

made their transfer more difficult. The machinery of international lending which until the crisis provided the means of getting over transfer difficulties ceased to operate. Politically, the world was not yet ripe for another revision of political debts so soon after The Hague Agreement. The increasing influence of extreme nationalists in Germany as shown by the results of the elections in September 1930, and the existence of a strongly nationalistic and uncompromising Government in France, prepared the stage for political conflicts with grave economic and financial repercussions.

Last, but by no means least, the position of the pound was highly vulnerable. The cost of production in Great Britain failed to adjust itself to the world level, and the deficit of visible trade increased. Nor was there any hope of obtaining any adjustment in the cost of production under a Labour Government, or to improve the trade balance by overcoming the Free Trade tendencies of that Government. At the same time, the budget became unbalanced to an alarming degree. This may be attributed in part to the economic depression and in part to the policy of spending of the Labour Government, but its fundamental cause was the existence of a huge public debt which deprived the budget of its elasticity. While taxation was being reduced all over the world, it remained in the close vicinity of its maximum level in Great Britain throughout the period of boom and slump. There was no margin available for meeting situations such as the one that had arisen through the economic depression. A slight decline in the yield of taxation and a slight over-spending on the part of the Labour Government brought about a budgetary crisis. In addition, there were the huge foreign balances in London, whose holders were beginning to feel uneasy. The large extent to which London was committed in Germany and Central Europe was also a potential source of danger. If, by any chance, the crisis had come to an end during the first half of 1931, all these potential sources of instability would have remained in existence and sooner or later they would have given rise to an acute financial crisis. There was little chance of a material recovery of commodity prices from their 1931 level, so that hopes of any fundamental improvement through such developments were rather slender. In the circumstances, the financial crisis of 1931, far from being the result of accidental developments, was the logical outcome of the situation and of the events that preceded it.

CHAPTER XXVII

THE CRISIS IN CENTRAL EUROPE

(1) The Creditanstalt Affair

During the first two months of 1931 optimism began to revive. In March, however, fresh clouds began to appear on the international horizon, and this time in the form of political difficulties. The scheme of an Austro-German customs union put forward at a rather inopportune moment by the Government of Dr. Brüning threatened to develop into a first-rate international conflict. The uneasiness it caused was sufficient to check the development of the sentiment of guarded optimism that was beginning to show itself. The real shock did not, however, come until two months later.

In May 1931 the world was startled by the announcement that the Austrian Creditanstalt was to undergo a drastic reconstruction. Until the eve of this announcement, it was considered one of the best-established banks on the Continent. It controlled practically 75 per cent of Austria's banking and industrial interests, and held important participations all over the Succession States, the Balkans, and even in Western European centres. As it had always been considered to be of first-class standing, it obtained large amounts of credits abroad, and British, American, French, Dutch and Swiss banks were heavily involved. The announcement of its difficulties was followed by a run of depositors, and foreign creditors also endeavoured to call in their credits. While local depositors were paid out freely, a moratorium was arranged with the foreign creditors, pending the negotiation of some definite arrangement. The Austrian Government was prepared to guarantee the claims of foreign creditors, but negotiations took some time. Meanwhile the general run on the Austrian banks continued; the exchange position and the internal position became grave. It appeared unlikely that a crash could be avoided without immediate foreign assistance. Negotiations were, therefore, initiated to secure credit from a group of Central Banks headed by the Bank of England. France declared herself to be prepared to participate in the transaction.

(2) French Policy

Unfortunately, at the eleventh hour the French Government sought to obtain political advantages from Austria's plight. The Austrian Government was presented with an "ultimatum" stating that unless it was prepared to renounce the customs union with Germany the French Government would withhold financial assistance. The circumstances were such as to make it appear almost impossible to make other arrangements as an alternative to the French participation in the scheme. Notwithstanding this, the Austrian Government preferred to resign rather than submit to the terms dictated from Paris.

It seemed as though Austria would be plunged into financial chaos. To avoid this, the Bank of England stepped in and provided the whole amount of £5 million required. The collapse was thus averted, and the foreign creditors of the Creditanstalt concluded a standstill agreement pending the definite settlement of the terms of the Austrian Government's guarantee of their claims. The immediate danger to Austria was thus over, but the shock proved to be too much for the Central European financial system to withstand. The wave of distrust created by the Creditanstalt crisis affected both Germany and Hungary. Foreign credits were being withdrawn in great haste, and the gold reserves of the Central Banks were declining rapidly throughout June.

(3) The Hoover Moratorium

It was at this stage that President Hoover made his proposal of a twelve months' moratorium for both reparations and war debts. Had the moratorium been proposed and accepted some months earlier, it might have averted the Central European financial crisis, for it was mainly on account of the existence of reparations that the foreign creditors of Central Europe were so highly sensitive towards unsettling developments in that part of the world. The general fall of commodity prices increased the burden of reparations, while the world-wide economic depression reduced the possibility of paying reparations either through exports or through fresh external borrowing. It was evident that sooner or later France would have to be asked to consent to some drastic modification of the Young Plan. The Franco-German disagreement on the Austrian customs union created pessimism as to the prospects of French concessions regarding reparations. Hence the nervousness of foreign creditors of Germany at the time of the Creditanstalt crisis.

Unfortunately, the French Government was reluctant to agree to the proposed terms of the Hoover Moratorium, and prolonged negotiations deprived the gesture of its psychological effect. In any case, however, it was evident that a moratorium of twelve months could not, in itself, help much at that stage. The commercial creditors of Germany were anxious to liquidate their commitments before the moratorium expired. Thus, when the agreement was reached which subsequently proved to be of fundamental importance in the development of the reparations and war debts problem, it fell hopelessly flat. It was unable to check the heavy withdrawals of funds from Germany.

The Reichsbank obtained substantial international credits, but they proved to be inadequate to meet the run and were soon used up. At the same time, there were heavy withdrawals from Hungary, and to a less extent from other countries of Central and South-Eastern Europe.

(4) The German Banking Crisis

The withdrawal of foreign credits caused considerable embarrassment to some of the German banks. It was an open secret that in accordance with their pre-war custom, German banks were using short-term credits to a large extent for financing medium-term transactions. They found it difficult, therefore, to provide the funds at short notice, especially as simultaneously with the withdrawals of foreign credits, there was also a run of depositors. The failure of a leading industrial concern, the "Nordwolle", resulted in a run on the Darmstädter und Nationalbank, while other banks were also faced with heavy withdrawals of deposits. An attempt of the German Government to support the banks with the aid of a joint action by all banks failed as a result of the refusal of one or two strong banks to participate in the support of their weaker rivals. On July 13 the Darmstädter und Nationalbank had to suspend payment and the German Government declared a moratorium on both internal and external payments.

The result was a general banking crisis all over the Continent. In almost every country some banks got into difficulties. In a number of countries it was necessary to declare a moratorium, while in other countries important banks suspended payments. The banking creditors were calling in credits in every part of the world, forcing their debtors to liquidate stocks in haste. The immediate consequence of the financial crisis was thus an aggravation of the world economic crisis.

(5) The "Standstill"

The German Government, following the Austrian example, came to the rescue of the banks in difficulties and granted assistance to them on a very extensive scale. At the same time, strict measures of credit restriction were applied to strengthen the position of the Reichsbank which had to take over large amounts of frozen assets. It is open to discussion whether it would not have been wiser for the German Government to allow the reichsmark to depreciate instead of declaring moratoria, and taking deflationary measures. The depreciation of the reichsmark would probably have been exploited by the extreme nationalists, but they exploited, in any case, the deflationary measures. From the creditors' point of view, a depreciation of the reichsmark might have made it easier to provide for the transfer of payments. On the other hand, it would have made it more difficult for individual creditors to find the larger amount of reichsmarks required for making payments abroad. It is certain that a depreciation of the reichsmark would have produced at least as grave repercussions upon the international monetary situation as did the act of moratorium.

In August, the moratorium on internal payments was somewhat relaxed, but the foreign creditors had to consent to the conclusion of a so-called standstill agreement by which they agreed not to call in their credits from Germany, in return for which certain limited repayments were made and the interest payments were maintained. Similar standstill agreements were concluded with Austrian and Hungarian banks, and in a number of other countries bank credits became frozen as a result of one-sided measures taken by the Governments concerned. Practically all banks in the lending centres became thus landed with large amounts of hopelessly frozen credits. It was feared that their immobilisation might lead to fresh banking troubles, and in fact there were runs on banks owing to this consideration in Switzerland and in the United States.

(6) Was the Crisis Inevitable?

The world was thus plunged into a financial crisis of first-rate magnitude as a result of developments in Central Europe, just at the moment when it began to hope to recover from the economic depression. It is argued sometimes, that but for the Creditanstalt crisis, the financial crisis of 1931–3 would never have occurred. Indeed, there is at least one authority who

regards the crisis as the result of the attitude of one director of the Creditanstalt who refused to sign the balance sheet which gave too optimistic a picture of the situation. It is always difficult to say what might have happened, but in the present case it was evidently not the attitude of a single individual nor the situation of a single banking institution that determined the course of events. Had the Creditanstalt concealed its unfavourable position by the optimistic valuation of its assets as so many other banks were doing at the time, the financial crisis would have taken place nevertheless. The financial position of Central Europe was highly vulnerable, and something was bound to happen to cause a run of foreign creditors. Already on two occasions, in 1929 when the Young Committee disagreed in Paris and in 1930 when the National Socialists won a large number of seats at the general election, there were runs on Germany, and it is certain that the aggravation of the conflict on the customs union with Austria, or the victory of the National Socialists—which was, in any case, probably only a question of time—would have provoked a run of first-class magnitude, resulting in a Central European financial crisis in 1932 or 1933 instead of 1931.

The fact that the world was fated to go through a violent financial crisis does not, however, exonerate from the blame those who had a share in the responsibility for the Central European crisis at the time and in the form it occurred. The French policy of Versailles bears a large share of this responsibility. It is largely owing to excessive reparations demands that Germany contracted huge external debts. It was the policy of keeping Germany down by financial weapons that led to the crisis. Conceivably had France collaborated sincerely in the assistance to Austria without trying to obtain political concessions as a price for her financial support, the run on Central Europe might have been stopped in good time.

The attitude of Germany was also largely responsible for the crisis. The Government, forced by the increasingly nationalistic trend in the electorate, put forward its customs union scheme at a most inopportune moment, thereby creating an atmosphere in international politics which bred distrust in the financial stability of Central Europe. The selfishness of the German banks in refusing to support their weaker rivals must also bear a fair share in the responsibility for the crisis.

Creditors of all nations are also to blame, owing to the recklessness with which they lent to Germany and Central Europe before the crisis, and also owing to their panicky attitude after

the crisis. But for the ruthless cutting of credits by American and other banking creditors of Central Europe, the crisis would not have occurred. The dangers of embarking upon international banking without adequate experience have manifested themselves distinctly during the Central European crisis. It was for the most part the financial centres which had no traditions in carrying foreign customers in difficulties that called in credit on such a scale that debtors had no alternative but to stop payment. The ambitions of American, French and other banks to experiment in international banking at a highly critical period proved to be very costly not only to themselves but to the rest of the world. The borrowers are, however, to blame to at least the same extent. Their attitude that credits were simply forced upon them is simply absurd. In the light of the circumstances in which they borrowed and in which they used the funds obtained, their attempts to play the part of innocents lured to their ruin by cunning money-lenders appear somewhat unconvincing. It is thus evident that the blame for the financial crisis in Central Europe is shared by most parties concerned.

CHAPTER XXVIII

THE CRISIS OF THE POUND

(1) Weakness of the Technical Position

From the very outset it was evident that the financial crisis would not be confined to Central Europe. The moment it attained its climax in Germany in the form of a general moratorium on banking payments, it was inevitable that it would produce grave repercussions upon the pound. As we said in an earlier chapter, the pound was in any case vulnerable, as a result of its over-valuation in terms of other currencies, the rigidity of British costs of production, and the excessive burden of public debts. The gold reserve of the Bank of England was very small, and the amount of short-term claims on foreign centres which could be mobilised at short notice was also inadequate compared with the amount of London's liabilities to foreign centres.

The weakness of the technical defences of sterling was not duly realised until the publication of the Macmillan Report which disclosed the fact that while short-term credits granted by London amounted to some £150 millions only, foreign deposits and bill holdings in sterling amounted to over £400 millions. In addition, it was generally known that foreign holdings of 5 per cent War Loan alone amounted to hundreds of millions of pounds. The figures of the Macmillan Report were published at a most inopportune moment, in the middle of the Central European crisis. As a large part of the £150 millions of short-term credits granted by London banks to foreign debtors became frozen as a result of the crisis, the discrepancy between liquid assets and sight liabilities was evidently even more pronounced than it appeared from the figures of the Macmillan Report. This fact in itself was sufficient to inspire fears in the minds of foreign holders of sterling. Confidence in sterling was, in any case, only half-hearted since its persistent weakness during the greater part of 1929 and 1930 gave a foretaste of the fundamental factors working against it.

The political factor also contributed towards undermining

confidence in sterling. It was well known that the French authorities held considerable balances in London. On the basis of past experience it was feared that they would use their financial power for political ends. The French Government strongly resented the intervention of the Bank of England in the Creditanstalt affair, since it assumed that it was thanks to the British support granted to Austria that the latter was unwilling to submit to the French terms. Although the fact is that the Austrian Government refused to comply with the terms of the French ultimatum before the British support arrived, the clash created none the less considerable tension between London and Paris. It was feared that, as on previous occasions, the consequence of this tension would be French withdrawals of gold from the Bank of England, especially as there was profound disagreement between the two governments concerned over the Central European political problem.

(2) The Flight from the Pound

Throughout the second half of July, there were heavy withdrawals of foreign deposits from London. The Bank of England lost a large amount of gold in spite of having used up its modest dollar reserve in support of sterling. To some extent, these withdrawals were due not so much to fears of a depreciation of sterling, as to distrust towards banks which were known to have committed themselves deeply in Central Europe. It must be said that most foreign Central Banks displayed an exemplary loyal attitude towards the Bank of England by refraining from selling out their sterling balances. Even the Bank of France, in spite of political disagreement, maintained its balances, though indirectly it may have contributed to the run by transferring some of its sterling holding to the Bank of Spain in the form of a loan for the purpose of supporting the peseta. It was evidently against the interests of France that sterling should depreciate, and in the eleventh hour the French authorities declared themselves prepared to grant their support.

Accordingly, a Franco-American credit of £50 millions was arranged by the Bank of England, and at the same time the bank rate was raised from 2½ per cent to 4½ per cent. The amount of this credit was, however, far too small to inspire confidence amidst the general run. The wave of distrust became intensified with the publication of the May Report which disclosed a hitherto unsuspected degree of deterioration in

public finance. Day after day the authorities had to draw upon their foreign credits which were dwindling down with an alarming rapidity. They also committed a series of tactical errors in their methods of defending the pound, which are described in detail and criticised in the author's earlier book, *The Tragedy of the Pound.* It was not, however, these tactical errors that were responsible for the ultimate result. Both fundamental and technical factors were so strongly against the pound that even the most skilful tactics could only have delayed the inevitable by a few weeks.

(3) Suspension of the Gold Standard

The conclusion of a second credit of £80 millions did very little to alter the situation. The run continued and the credits were being used up rapidly. Even though the change of Government improved the chances of strengthening the defence of sterling through balancing the budget and introducing a customs tariff, it took place too late to make any difference. The drastic measures of taxation which were introduced by the National Government in September 1931 failed to produce any reassuring effect. Owing to the parliamentary situation, it was impossible to adopt a customs tariff without a general election, and it was evident that sterling was not in a position to stand the strain of an electoral campaign. In any case, France threatened to discontinue to support sterling if any customs were introduced against French goods.

Throughout September, sterling was subject to strong selling pressure as a result of the withdrawal of foreign balances, speculative operations and a small scale flight of British capital. It was becoming increasingly evident that before long the Franco-American credits would be exhausted. The disturbances in the Atlantic Fleet at Invergordon, as a result of the reduction of wages to naval ratings—an incident which was grossly exaggerated abroad—sealed the fate of sterling. The flight from the pound became accentuated and on September 21 the gold standard had to be suspended.

(4) The Bank-Rate Controversy

The British authorities have been subject to much unjustified criticism, both at home and abroad, owing to the fact that they did not attempt to check the flight from the pound by raising the bank rate to a sufficiently high degree, and by enforcing drastic credit restrictions. More dogmatic nonsense has been written on this point than on almost any other con-

troversial question in modern financial history. It is a characteristic example of the doctrinairism of bank rate worshipping economists. It is a conception which developed throughout the Nineteenth Century and during the early part of the Twentieth Century, that bank rate is an all-powerful weapon with which Central Banks are in a position to determine, in no matter what circumstances, the fate of their currencies. The application of this theory showed itself at its worst in 1914 when, confronted with a major crisis, the Bank of England raised its rediscount rate from 3 per cent to 10 per cent between July 30 and August 1. The absurdity of the situation thus created convinced practical experts that the increase of the bank rate to panic-level is useless as a means of fighting a major crisis, and that its excessive increase only accentuates the panic. Nothing, however, could ever convince an economic purist that one of his doctrines is subject to revision in abnormal circumstances. On the basis of pre-war experience, such purists are convinced that selling pressure on the pound can be stopped by an increase of the bank rate. It is true that in pre-war days, the selling pressure merely amounted to a few millions of pounds, so that it was easily corrected by raising the bank rate by 1 per cent. In 1931 the selling pressure amounted to hundreds of millions of pounds, but this fact did not alter the opinion of bank rate worshippers that it could be checked by raising the bank rate. If a selling pressure of, say, £10 millions before the war required an increase of the bank rate by 1 per cent, it was, to their minds, a matter of simple arithmetic to demand an increase of the bank rate by 10 per cent in order to check the selling pressure amounting to a hundred million pounds! They overlooked the fact that the factor of confidence cannot be expressed in terms of simple arithmetic.

The reason why foreign holders of sterling were withdrawing their funds was not because they were dissatisfied with the yield but because they were afraid of a capital depreciation through the collapse of the pound. It is true that an increase of the bank rate affects the exchange also in the long run by causing a fall in commodity prices, and thus improving the trade balance. It was, however, unthinkable that such a result could be achieved in a sufficiently short time and on a sufficiently large scale to save the pound. A capital movement running into hundreds of millions of pounds can hardly be expected to be corrected by an improvement of the current trade balance. Even if it had been possible to bring about a slump of prices by Draconian deflationary measures at short notice, it is most

unlikely that foreign countries would have been prepared to put up with the dumping of British goods on their markets.

(5) Deflation would have Defeated its Object

In any case, in 1931, the British economic and financial system was not in a position to withstand the shock administered by the increase of the bank rate to a fantastic figure and by drastic restrictions of credit. Two years of deflationary depression following upon the general slackness of trade that had prevailed incessantly ever since 1920 had weakened the resisting capacity of British trade to no slight degree. An increase of the bank rate to 12 per cent, which was suggested by deflationists as the proper measure for the defence of the pound, would have brought about a large number of commercial failures. This again would have undermined confidence in banks, and it is doubtful whether even the big clearing banks would have remained immune from the wave of distrust thus. generated. Far from checking the flight from the pound, these drastic measures would have accentuated panic. Anyone with some sense of reality was bound to realise this.

Evidently any deflationary measures sufficiently drastic to produce an adequate effect upon prices would have defeated their object. Barring this solution, the only way in which the pound might conceivably have been saved would have been by a gradual application of measures aiming at balancing the budget, reducing costs of production and improving the trade balance. It is doubtful if such a policy would have been practicable even if the British Government had had sufficient resources at its disposal to defend the pound in the meantime. This, however, was not the case. By the end of August foreign credits to an amount equivalent to the whole of the Bank of England gold stock were contracted, and by the 21st September all but a small fraction of these credits was used up. Although the French authorities were prepared to grant further credit, American interests refused to participate in the transaction, which thus fell through. In any case, a new French credit would have been subject to a condition which would have made it more difficult to defend sterling in the long run, namely, that no customs duties should be raised against French goods.

(6) Depreciation of £ was Inevitable and Desirable

It is evident that the depreciation of sterling was inevitable. What is more, it was even desirable as a means of breaking the international deadlock brought about by the fall in commodity

prices. From a purely British point of view, it was desirable, since it paved the way for a reduction of the burden of the public debt. In his memorandum of dissent added to the Macmillan Report, Lord Bradbury pointed out that the real cause of the economic troubles of Great Britain before the crisis was the burden of the unproductive debt. It is a pity that he had not the courage of his convictions to infer the only possible conclusion, namely that the only remedy for the situation would be a depreciation or a devaluation of the pound. While admitting that there was no hope of a substantial rise in the world level of prices, with questionable logic he endorsed the conclusion of the majority of the Macmillan Committee that the reduction of the gold value of the pound or the suspension of the gold standard would be most undesirable. And yet it must have been evident that this was the only possible way in which fictitious capital could be reduced in Great Britain.

But perhaps it is as well that the British Government did not assume the responsibility for deliberately abandoning the gold standard. Great Britain was swept off the gold standard and was thus forced by irresistible influences to adopt the solution which was in accordance with her fundamental interests.

(7) Political Aspects

There is also another aspect of the question. Had Britain struggled on to maintain the pound the result would have been a decline of her international prestige, both from a financial and from a political point of view. As it was, the experience of having to appeal to the French authorities to refrain from withdrawing their balances from London was humiliating, and the evidence of the extent to which the stability of the pound was at the mercy of the French authorities between 1927 and 1931 was highly detrimental to the prestige of London as a financial centre. The fact that Great Britain alone of all European belligerent countries restored the pound at the price of heavy sacrifices was forgotten in face of the evidence of the inadequate strength of sterling. The experience of the years preceding the suspension of the gold standard proved that in matters of finance it is not so much past record as present position and future prospects that matter.

From a political point of view, it would have been impossible for Great Britain to pursue an independent foreign policy so long as she depended upon French support for the stability of the pound. In any case, the situation in which any material

extra expenditure endangered the stability of the pound was calculated to undermine the political authority of Great Britain abroad. It was obvious that Great Britain was not in a position to spend an adequate amount on her defence, and for this reason her word carried relatively little weight in the councils of the nations after the war. A drastic depreciation of the pound was the only way in which Great Britain could possibly put an end to this state of affairs. Thus, when she suspended the gold standard, she did the right thing, even though admittedly she tumbled upon the right solution by mistake.

CHAPTER XXIX

THE CURRENCY CHAOS

(1) Immediate Effects of Sterling's Slump

The depreciation of sterling that followed the suspension of the gold standard delivered a staggering blow to the international monetary structure. Its immediate effect appeared to be little short of a major disaster, and it appeared to many people as though the change was for the worse in every way. Foreign holders of sterling balances suffered big losses. Amongst them there were a number of Central Banks whose note cover fell considerably as a result of the depreciation of their sterling reserves. Foreign trade became disorganised through the currency chaos that followed the depreciation of sterling. There was a world-wide wave of distrust; every currency and almost every bank was regarded with doubt and suspicion. The panicky atmosphere created by the fall of sterling was largely responsible for runs on a number of banks which suffered little or no loss through the fall of sterling. Another wave of bank crises swept over a number of countries. France in particular was affected adversely by the suspension of the gold standard in Great Britain. Until then, she had resisted the crisis to a remarkable degree, but from September 1931 onwards her economic and financial situation became aggravated. There was a run on most banks, and one of the leading banks, the Banque Nationale de Crédit, could only be saved from failure by the drastic action of the Government, its support costing the Treasury nearly a milliard francs.

There was an outcry of indignation in the world's Press against the action which brought about such consequences. The fact that Great Britain did not go off the gold standard but was swept off it was almost entirely ignored. Nor was the extent to which the change was inevitable realised. The losses suffered through depreciation of sterling were grossly exaggerated, especially as far as Central Banks were concerned. In almost every country the Governments indemnified the Central Bank for their loss on their sterling balances, and in almost every country the Governments derived direct or indirect benefit

from the depreciation of sterling. They nearly all had Government loans, Government guaranteed loans or loans by public or semi-public corporations in sterling denomination, and the extent to which the burden of these loans became reduced through the depreciation of sterling went a long way towards indemnifying the Treasuries for their losses on Central Banks' sterling balances. While a great deal was heard about the losses of foreign holders of sterling, little or nothing was heard about the gains of foreign debtors owing debts in terms of sterling. And yet these fixed interest-bearing debts which benefited by the depreciation of sterling amounted to well over a milliard pounds. The total relief provided to debtors was considerably larger than the loss inflicted upon the holders of sterling.

(2) Effect on International Trade

The chaotic conditions in the sphere of international finance and trade, deplorable as they were, settled down to a greater or less extent after a few months. The extent to which fluctuating exchanges handicap foreign trade is usually grossly exaggerated. On the other hand, it is true that the depreciation of sterling and other currencies gave rise to the erection of new customs barriers, the introduction of quotas and various other methods of interfering with foreign trade. These obstacles survived the chaos that immediately followed the suspension of the gold standard. They accentuated the declining tendency in the volume of world trade.

How far was the depreciation of sterling responsible for this? It was evidently the direct cause. If, however, we examine the situation from a broader point of view, we cannot escape the conclusion that the real reason for most troubles the world had to put up with after the suspension of the gold standard in Great Britain was that all other countries did not follow her example. It is sometimes said that sterling did not go off gold but it was gold that went off sterling. There is profound truth in this theory. If, owing to the scarcity and maldistribution of gold, its commodity value increased to an inconveniently high degree, there was no reason whatever why the whole world should consider it its sacred duty to put up with all inconveniences by maintaining the currencies linked with gold at a fixed ratio. Had all or most countries followed Great Britain's example, the result would have been an intensified currency chaos for some months, after which the currencies would have settled at a lower level at which it would have been possible to

revive trade both internally and internationally. It was not the suspension of the gold standard by Great Britain, but the reluctance of other countries to follow her example that was responsible for the prolonged depression.

(3) Currencies following Sterling's Example

A number of countries followed the pound, either instantaneously or after a brief interval. All the currencies of the British Empire, with the exception of the Canadian dollar and the South African pound, followed sterling immediately. After a few days of hesitation and resistance, the Scandinavian currencies went off gold, and a little later Finland followed their example. The Portuguese escudo remained more or less stable in relation to sterling. In December 1931, Japan suspended the gold standard after having lost a large amount of gold as a result of a flight of capital to the United States. Greece, South Africa and other countries followed sterling's lead somewhat reluctantly, and with considerable delay.

Thus, in 1931, as ten years earlier, the world became divided into two groups of countries, one of which suspended the gold standard, while the other defended their currencies by means of deflation. Although it is customary to talk about "Sterling Bloc" versus "Gold Bloc", in reality the division is not so simple. A number of countries suspended the gold standard without linking their currencies to sterling. For instance, Japan allowed the yen to depreciate far beneath its parity with sterling. The Canadian dollar hovered for some years somewhere half-way between sterling and gold. On the other hand, a number of currencies remained stable in relation to gold without actually being on a gold basis. Some of them gradually depreciated, first unofficially, then officially. Thus, it is not as easy to draw a line of division between the two groups as it was in 1921.

(4) Attacks on Gold Currencies

One of the immediate consequences of the depreciation of sterling was a severe attack on the dollar. This was due to the wholesale repatriation of foreign balances, official and unofficial, from New York. Owing to losses suffered on sterling balances, some holders repatriated their dollar balances in great haste. As a result, the dollar declined frequently below gold export point, especially as shipping facilities were not always sufficient to make it possible to export gold on a sufficiently large scale in accordance with the normal functioning of the gold standard. In October 1931 the heavy outflow of gold from

New York created a panicky atmosphere, and it was feared that the United States might follow Great Britain's example. From time to time, the outflow of gold from New York was resumed through the first half of 1932.

Other currencies on the gold basis were also in turn subject to attacks. Indeed, the departure of sterling from gold undermined confidence to such a degree that no currency was trusted any longer. The floating international balances which played such a fateful part in forcing Great Britain off the gold standard were being shifted from centre to centre at frequent intervals, causing incalculable adverse movements in various exchanges.

(5) Effect on Great Britain

How did the depreciation of the pound affect Great Britain? The first impression after the 21st September was one of intense relief, the extent of which was not adequately realised by those who relied on the Press for impressions. "Thank goodness we are off the gold standard!" was the byword, which was heard in trains, in the street, in restaurants and in barbers' shops. During the months that followed the suspension, there were more smiling faces visible than for many years past in spite of the heavy burden of taxation which was increased in order to balance the budget. This, together with the increase of the bank rate to 6 per cent, constituted a deflationary measure which showed that the British authorities had no intention of inflating. In themselves, however, these measures would not have been able to check the slump of sterling through the flight of foreign balances, and to a certain extent of British capital. A factor of considerably greater importance was the victory of the National Government at the general election in November, and the subsequent establishment of a protective customs tariff. In addition, the dishoarding of Indian gold on a large scale provided also a valuable support for sterling, since the proceeds of a large part of the gold sold in London were left there.

The effect of the depreciation of sterling upon British trade was almost instantaneous. Partly owing to the psychological effects of the change and partly owing to the actual increase in competitive capacity, there was a wave of optimism which went a long way towards assisting in the revival. Although the increase in taxation and the all-round cuts in wages, salaries, doles and pensions enforced by the Government and by private employers reduced purchasing power, notwithstanding this, trade soon began to benefit by the depreciation of sterling.

It may well be asked whether it would not have been wiser if

the British Government had allowed sterling to find its level without checking its depreciation with the aid of deflationary measures. Evidently, the degree to which sterling depreciated did not provide an adequate relief from the burden of the internal public debt. Indeed, after a comparatively moderate rise, commodity prices settled down in the vicinity of their pre-war level so that the burden of the seven milliards of paper pounds of public debt was exactly the same as seven milliards of gold pounds would have been before the war. There were two reasons why the Government resisted to the utmost the depreciating tendency of sterling. Firstly, the authorities were still inspired by essentially orthodox principles, and were determined to keep the inevitable depreciation of sterling within the narrowest possible limits. The second reason was that the Government had to pay off Franco-American credits amounting to 130 million pounds, the sterling equivalent of which increased in proportion to the depreciation of sterling. They also needed a recovery of sterling to enable them to buy the francs and dollars required in the foreign exchange market. But for their orthodox monetary policy, the currency chaos that followed the suspension of the gold standard would have been much more pronounced and much more prolonged.

(6) End of Currency Chaos

By the end of 1931 the currency chaos was virtually over. Most of the countries which wanted to suspend the gold standard had done so between September and December, and their currencies, together with sterling, had passed the climax of their first depreciation. After the turn of the year it became evident that none of the currencies which went off gold was likely to follow the German mark and other Central European currencies which depreciated after the war. While they were to depreciate further in subsequent years and fluctuate within wide limits, it was evident that the currency troubles would not even attain the same degree as the troubles of the French franc between 1924 and 1926, let alone the crisis of the mark.

In the foreign exchange market, conditions gradually settled down. Immediately after the suspension of the gold standard in Great Britain, it was difficult to deal in large amounts, especially in forward exchanges, not merely because of the highly speculative risks dealers had to take, but also because few names were considered good enough to be taken in forward dealing. This absence of an adequate forward exchange market was a severe handicap to international trade, since it

reduced the possibility of covering exchange risks at the very moment when such cover was most essential to importers and exporters. After a few months, however, a more or less normal forward exchange market began to develop, and this difficulty was overcome.

The currency chaos was thus short-lived, and comparatively moderate. Although it was followed by a prolonged period of unstable exchanges, which at the time of writing is not yet over, never again did conditions become chaotic. Even after the suspension of the gold standard in the United States, the foreign exchange market retained its composure and the world took the shock better than that caused by the suspension of the gold standard in Great Britain. The net result of the currency chaos of 1931 was that the fundamental position of sterling and a number of other currencies, as well as their technical defences, improved, and internal trade conditions, in part of the world at any rate, changed for the better. On the other side of the picture was the accentuation of the international wave of distrust, uncertainty in international trade and finance and decline in trade of countries which remained on the gold standard. But of this more will be said in later chapters.

In dealing with sterling and other depreciated currencies in this part of the book, we propose to confine ourselves largely to the deflationary effect of their depreciation upon the rest of the world. The reflationary influence that the depreciation of various currencies produced will be dealt with more especially in Part IV of the book.

CHAPTER XXX

STERLING'S SUPREMACY

(1) The Flight to the Pound

It is the irony of fate that while all the efforts between 1920 and 1931 to restore sterling to its pre-war supremacy at the price of heavy sacrifices failed, within a few months of the suspension of the gold standard it assumed a commanding position in world finance that overshadowed, in a sense, even its pre-war supremacy. While sterling was retained at its old parity, it was a highly vulnerable currency at the mercy of any adverse pressure, natural or artificial. It is true that for a few months after September 1931, sterling was the plaything of speculators, and its prestige declined to a low ebb. After the turn of the year, however, it underwent a surprisingly sudden recovery. The successful efforts to balance the budget through increased taxation and economies restored confidence in sterling. This, together with improved chances of export trade and the flow of gold from India, reversed the trend of the exchanges. Before long, there was a wholesale repatriation of British capital that took flight abroad. As a result, the Government was able to acquire a sufficient amount of foreign exchanges to repay a large part of the Franco-American credits contracted in defence of sterling. This provoked another wave of buying pressure, and this time the repatriation of British funds was coupled with a heavy flow of foreign capital to London.

Before long the British authorities began to feel an acute *embarras de richesse*. They covered their full requirements of dollars and francs for the repayment of the outstanding balances of the Franco-American credits, and funds were still streaming towards London. In order to prevent an unwanted appreciation of sterling, the authorities continued to buy foreign exchanges, thus accumulating a substantial reserve. They regained control over sterling and were in a position to determine the movement of the exchanges. Their power in the international exchange market was practically dictatorial. Unfortunately, they were too timid to make use of their power, and early in March 1932 in order to avoid having to acquire more

dollars and francs they decided to let sterling find its own level. The result was a sharp appreciation.

(2) The Exchange Equalisation Account

In the following month the Government decided to improve its facilities for operating in exchanges, and the budget statement contained proposals for the establishment of the Exchange Equalisation Account which was to play such an important part in international finance during the following years. Endowed with resources amounting to £175 millions, that account was established for the purpose of reducing abnormal fluctuations of sterling, without at the same time attempting to stabilise it or to counteract fundamental trends.

The flight to the pound continued throughout the first half of the year, partly as a result of increasing confidence in sterling and partly in consequence of distrust in the dollar and other gold currencies. The recovery of sterling had a profound influence upon the international economic situation. The effect of its depreciation in 1931 was a further fall in commodity prices in the gold countries, while the recovery of sterling between March and June 1932 tended to reverse this movement. The relapse of sterling that occurred towards the end of 1932 brought about another relapse in world prices.

Thus, while until September 1931 the tendencies of world prices were largely determined by monetary developments in the United States, from that time onwards until the suspension of the gold standard in the United States in April 1933 it was the movements of sterling that became the leading factor. The predominant part sterling played in world economics during that period was equalled by the predominant part it played in world finance. The operations of the Exchange Equalisation Account were the most important influence on the foreign exchange market.

(3) Influence of British Authorities

The British authorities were, in fact, in a position to save any currency affected by a wave of distrust by supporting it or to allow it to go under by abstaining from supporting it. From time to time, when the dollar or the franc were subject to selling pressure, it was the operations of the Exchange Equalisation Account which relieved the pressure. It is true that the object of its operations was not to support the gold currencies which were being attacked, but to prevent an unwanted appreciation of sterling. As, however, this could not be done without buying

the currencies which were weak, the effect was the same as if they had been supported deliberately. Towards the beginning of 1933, the British authorities decided, however, to change their policy; instead of accumulating exchanges and running the risk of their depreciation they converted them immediately into gold. As a result, they ceased to support the exchanges which were in difficulties, and the heavy outflow of gold from the United States, which was one of the reasons for the suspension of the gold standard there, was partly the consequence of this change of policy. Those who are inclined to blame the British Government for having withdrawn gold from time to time from the reserves of foreign Central Banks, thereby causing inconvenience to the latter, should remember that the Exchange Equalisation Account operated in gold in both directions. When sterling was weak and had to be supported the Exchange Equalisation Account resold the gold, thus making good any inconvenience caused by its purchase during periods when sterling was undesirably firm.

British influence became equally predominant on the international money market. The bank rate was gradually lowered from 6 per cent to 2 per cent, and this brought about a world-wide decline in money rates. The decline did not confine itself to rates on short loans, but gradually began to affect also long-term loan rates. The conversion of the 5 per cent War Loan was the most important step in that direction. The existence of over two milliards of pounds of War Loan, which was unable to rise above par because of the Government's right to repay or convert at any time, provided a formidable obstacle to the reduction of loan rates in Great Britain and abroad. The bold spirit with which this problem was tackled by the issue of a 3½ per cent conversion loan reaped its reward by the unexpected success of this operation. Interest rates in Great Britain have tended to decline ever since, and the road was open for foreign countries to follow this example. At the same time, however, withdrawals of funds by foreign holders of War Loan caused sterling to weaken and the Exchange Equalisation Account was unable to prevent altogether a decline.

It was not, however, this factor which was mainly responsible for the heavy depreciation of sterling towards the end of 1932. The main cause was the payment of the December 15 instalment of War Debt to the United States. The market anticipated heavy official purchases of dollars on an adverse market and owing to this sterling depreciated sharply towards the end

of November and the beginning of December. Subsequently, however, when it became known that payment would be made in the form of a gold shipment, there was a recovery of sterling. Its firmness was accentuated by the flight from the franc owing to the budgetary position, and after the turn of the year, by the flight from the dollar owing to the banking position in the United States. Thus, early in 1933, the Exchange Equalisation Account had to step in once more to prevent an unwanted appreciation of sterling. Again the experience of 1932 repeated itself. The sterling resources of the Exchange Equalisation Account were being used up rapidly for the purchase of gold, and even though fresh sterling resources were provided through the sale to the Bank of England of some of the gold acquired, a situation arose in which the authorities considered it necessary to allow sterling to appreciate. In April 1932 the budget statement provided for the addition of a further £200 millions to the resources of the Exchange Equalisation Account in the hope that this arrangement would prevent the recurrence of the same embarrassing situation.

(4) Conditions in Gold Countries

Meanwhile, conditions in countries on a gold basis were going from bad to worse. Exporters found it increasingly difficult to compete with those countries which had a depreciated currency, and the Governments had to protect the home market to an increasing degree by high tariffs and quotas. The defence of over-valued currencies necessitated also the establishment of a series of exchange restrictions in financially weak countries, which tended further to paralyse international trade. Drastic transfer restrictions were adopted by a number of debtor countries with inadequate gold resources, and the proceeds of exports became frozen.

Internally, deflation was going on unabated in the gold countries. Commodity prices were falling almost incessantly, partly because of a deliberate deflationary monetary policy and partly because of the effect of the appreciation of sterling upon world prices. The series of big failures in 1931 continued during the early part of 1932, when among others the Kreuger group collapsed. The budgetary situation in the gold countries was becoming increasingly difficult. Revenue was falling off owing to the contraction of trade and the fall of prices. All gold countries had to take drastic steps to balance the budget, and by the time the measures became effective, the further progress of deflation had created a fresh deficit.

Although most gold currencies strengthened their technical position through the increase of their gold reserves, the market remained distrustful towards them. At the slightest excuse, there was a flight from the dollar or from the franc or from some other gold currency. The adverse effect of over-valued exchanges upon the trade balances of gold countries began to manifest itself, and it resulted in deliberate deflationary efforts in many countries to bring down the cost of production. Thus, while the price level in Great Britain remained almost unchanged after September 1931, prices in all gold countries underwent a sharp decline. It was generally expected that some of them, at any rate, would not stand the strain much longer, but during 1932 Greece and the Union of South Africa were the only countries which abandoned the gold standard.

(5) Pressure to Stabilise Sterling

Ever since September 1931 pressure had been brought to bear upon the British Government from time to time to agree to a stabilisation of sterling. The Government refused, however, to follow this advice owing to the unsettled international conditions. It pointed out time after time that so long as war debts and reparations remained unsettled, and so long as international trade was subject to disturbing influences, there could be no question of stabilising sterling. While in some quarters it was believed in September 1931 that the period of instability would extend over a few weeks or a few months at the most, the Government envisaged a long period of sterling fluctuations. The position may best be compared with that prevailing in August 1914, when many people hoped that the war would be over after a short, swift campaign, but in reality the world had to settle down to a prolonged war of nearly four and a half years.

In one respect, these conditions improved to a noteworthy extent during 1932. After much hesitation, the French Government at last agreed at the Lausanne Conference in June to reduce its reparations claims to a relatively moderate figure, provided that the United States would cancel war debts. The favourable psychological effect of this decision was, however, cancelled out by the unwillingness of the United States to make any drastic changes in the existing war debt agreement, or even to prolong the moratorium on war debts. The British Government declared itself unwilling to stabilise sterling so long as this problem among others remained unsettled.

(6) An Orthodox Policy

It appeared as if at the end of 1932 sterling had passed the lowest point of its depreciation. But for subsequent developments in the United States, it is probable that sterling would have remained at a discount of approximately 30 per cent. The official policy was opposed to any further depreciation of sterling, and sooner or later it would have been stabilised at the highest possible rate compatible with the interests of export trade. No attention was paid in official circles to the necessity of adjusting the burden of public debt through a more drastic devaluation of sterling. Indeed, in spite of the inconvertibility and depreciation of sterling, the Government pursued a most orthodox financial policy. It opposed any expenditure such as slum clearance on a large scale, or a material increase in the Air defence, for fear of its effect upon sterling. It may be said that although sterling was off gold, the British Government behaved in every way as if the country were still on the gold standard, and as if the budgetary policy would have to be conducted in such a way as to pay due attention to the necessity of defending sterling at its gold parity.

It was not until the United States suspended the gold standard, and the dollar depreciated considerably in the autumn of 1933, that the British authorities reluctantly decided to allow sterling to depreciate further. But for the inflationary policy adopted by President Roosevelt, the chances are that sterling would have been stabilised once more at too high a level.

CHAPTER XXXI

THE CRISIS OF THE DOLLAR

(1) The Banking Crisis in the United States

The effects of prolonged world deflation began to manifest themselves to an increasing degree in 1933. In France they manifested themselves especially in the form of a growing budgetary deficit. In Germany the result was produced mainly in the form of a spectacular increase of unemployment, with repercussions on the political field. In the United States deflation provoked a banking crisis of unprecedented dimensions. It was this banking crisis more than the economic depression itself or the heavy outflow of gold that induced President Roosevelt to begin his regime by suspending the gold standard.

The origin of the American banking crisis lies in the heavy slump of securities, commodities and real property which resulted in the insolvency of a very large number of debtors. The Wall Street slump of 1929 delivered the first blow, since the drop in Stock Exchange quotations was so sudden that the margins of loans granted on securities were exhausted before the banks had an opportunity to realise the securities. A number of banks were, moreover, affected by the depreciation of their own security holdings. The banking system would have survived this shock, but the prolonged depression gave no opportunity to recover from it. Bad debts went on increasing and current earnings were at a low ebb owing to the depressed state of business. The Central European crisis inflicted further heavy losses and immobilisations upon a number of American banks, some of which had committed themselves in Germany to an astonishing degree. Further banking losses arose from the depreciation of sterling. The main source of the difficulties was, however, the fall in produce prices which resulted in the insolvency of a large proportion of agricultural debtors. The price of land fell to a fraction of its boom level, and it was impossible to realise any mortgages.

(2) Run on Banks

Throughout 1932 efforts were made to assist the banks in difficulties. The Reconstruction Finance Corporation granted

loans amounting to milliards of dollars to banks and various other enterprises. Notwithstanding these sacrifices, depositors were becoming increasingly distrustful. There were runs on a number of banks, and many of them received no adequate or timely support and had to close down. The situation became particularly aggravated between the presidential election in November 1932 and the change of regime in March 1933. After his defeat at the presidential election, President Hoover was unable or unwilling to take any drastic action during the remainder of his term of office. There was a kind of " interregnum " during which the public could not rely upon any effective action on the part of the Administration. The sudden recovery of sterling after its heavy fall in December 1932 resulted in a heavy flow of funds from New York to London, and the dollar was persistently around gold export point in relation to the European gold currencies.

What delivered the final blow was the publication of the list of loans granted by the Reconstruction Finance Corporation on the insistence of the Senate. The list disclosed staggering details about the extent to which support had to be given. The result was a panic all over the United States. Seized by a wave of distrust, the public regarded the majority of banks as unsafe, and there was a wholesale withdrawal of deposits. At the same time, the persistent outflow of gold, together with the internal banking situation, strengthened the doubts about the stability of the dollar and resulted in hoarding of gold on a large scale. Foreign holders of dollars, including foreign monetary authorities, converted their balances into gold and large amounts were withdrawn from the Federal Reserve Banks also on American account. The heavy losses of gold disclosed by the Federal Reserve returns week after week further aggravated the panic.

In February 1933 the situation was becoming intolerable. There was an almost universal run on the banks. In many cases there was no time to ascertain whether or not the banks were worth supporting, and they had to be closed down. In State after State it became necessary to declare temporary moratoria, so that by the time President Roosevelt assumed office in March, the whole economic system of the United States was on the verge of collapse.

(3) Suspension of the Gold Standard

As soon as President Roosevelt assumed office he decided to take drastic action. He declared a bank holiday for the whole

of the United States, and at the same time, he placed an embargo on gold exports. After a few days, a large number of banks which were considered sound were re-opened, while the rest remained closed pending further investigation of their position. Although the embargo on the export of gold remained in force, the American authorities continued to support the dollar at its parity. It was not until a month later that support was abandoned and the dollar was allowed to depreciate. While technically the gold standard was actually suspended on March 3, it was not until April 20 that the dollar effectively abandoned its gold parity. Internally the dollar ceased to be convertible after the termination of the bank holiday on March 10, and subsequently efforts were made to call in the gold withdrawn for internal hoarding before the suspension.

The suspension of the gold standard by the United States provoked an even stronger degree of indignation than the similar British act eighteen months earlier. While the main point of criticism against the British authorities was that they did not make adequate efforts to defend sterling by raising the bank rate and deflating ruthlessly, the American authorities were accused on the ground of deliberately " walking off the gold standard ", even though they were technically well in a position to defend the dollar. Indeed, while the British gold reserve was practically exhausted before the gold standard was suspended, the United States still possessed a huge gold stock at the time of the suspension, with the aid of which it would have been possible to maintain the dollar at its parity for a long time to come. The author must confess that he was also amongst those who at the beginning delivered bitter attacks upon the American authorities for having failed to make an attempt to defend the dollar. Subsequently, however, on closer examination of the circumstances in which the decision was reached, he arrived at the conclusion that President Roosevelt was right.

(4) Why the Dollar was Doomed

Even though technically it would have been possible to remain on the gold standard, in the long run it would have had to be suspended in any case. The only way to put an end to the panic was to arouse hopes for higher commodity prices and better trade, and it was evidently impossible to expect anything of that kind so long as the dollar was on the gold standard. Had thousands of banks been allowed to fail, the result would

have been a complete economic and even political upheaval, and a wholesale flight of capital which would have depleted the gold resources of the authorities. On the other hand, had the United States Government sought to save the situation by guaranteeing either agricultural and other indebtedness or bank deposits, the increase of the public debt thus caused would equally have produced the effect of completely shaking confidence in the dollar, and the flight of capital would have taken place all the same.

Possibly it would have taken a year or two before the depletion of the gold reserve swept the United States off the gold standard. There are many people who maintain that it should have been the sacred duty of the Washington Administration to allow the gold resources to be depleted before deciding to go off gold. Anybody with practical sense, however, is bound to reject the suggestion based on altogether misplaced moral considerations. Evidently gold was going off the dollar by appreciating in terms of commodities to an intolerable degree. In the circumstances the contention that the dollar ought nevertheless to have stuck to gold no matter what the cost cannot be upheld seriously. As for those who maintain that panic in the United States could have been cured by an adequately high bank rate, they might as well advise a pill as a remedy against an earthquake.

(5) Effect of Dollar Slump

The effect of the depreciation of the dollar after April 20, 1933, was similar to a large degree to the effect of the fall of sterling after September 21, 1931. Holders of dollars suffered heavy losses and international trade and finance which had been largely based on dollars since 1931 received a severe shock. The world, however, was better prepared in 1933 for the shock than it was in 1931, and its consequences were not nearly as grave as those of the suspension of the gold standard in Great Britain. Most Central Banks repatriated their dollar reserves in the form of gold shipments before the gold standard was suspended. While at the time when they were withdrawing gold and thus added to the embarrassment of the American authorities, they were subject to criticism, subsequent events justified their action. It is difficult to say whether in the absence of the wholesale repatriation of dollar balances by foreign Central Banks a situation would have arisen none the less in which the United States would have had to suspend the gold standard at the time she did suspend it. There can be no

doubt that the repatriation of foreign exchange reserves in the form of gold had a world-wide deflationary influence, and contributed to the fall in commodity prices in the United States. The extent to which this factor played a part in bringing about the American banking crisis should not, however, be over-estimated. We pointed out in Part II of this book that the degree to which the operation of the gold exchange standard actually caused a duplication of credit was very small, since few Central Banks actually issued notes against their foreign exchange reserves which were held more as a safety margin than as part of the actual legal note cover. This being the case the deflationary effect of the liquidation of the gold exchange standard must have been also comparatively moderate.

By March 1933 most of the financially weaker countries had already suspended the gold standard. Those who remained on gold were technically strong enough to withstand the shock administered by the depreciation of the dollar. Estonia was the only country that followed the example of the United States some months later. The rest of the gold group maintained the stability of their currencies. Needless to say the pressure upon them increased to a considerable degree. In addition to the competition of exports from countries of the Sterling Bloc, there was now also the competition from the United States to be faced. The depreciation of the dollar was bound to produce deflationary effect upon the gold countries, even though to some extent its effect was offset by a rise in internal prices in the United States and in world prices. It is an interesting question why it was that while the depreciation of sterling caused a universally deflationary effect outside the Sterling Bloc, and failed to cause a rise in commodity prices within the Sterling Bloc, the effect of the depreciation of the dollar was a rise in commodity prices in every country outside the Gold Bloc. There are many reasons for this difference in the effect of the depreciation of the two major currencies. In the first place, by 1933 the situation was more ripe for a recovery in commodity prices than in 1931. World prices had fallen well below their pre-war level and their decline was obviously overdone. Between September 1931 and April 1933 a large number of so-called "weak positions" all over the world were eliminated. Those firms which survived the crisis by 1933 were for the most part liquid, and were not likely to be compelled to throw their stocks on the market. International money conditions were on the whole also easier than in 1931, and even though cheap

money itself does not cause a rise in commodity prices, it certainly facilitates a rise caused by other factors.

Another set of reasons why commodity prices reacted differently from the decline of the dollar than from the decline of sterling lies in the difference in the rôles played by the United States and Great Britain in the world's economic system. Great Britain is a large buyer of staple products. Had she been alone in depreciating her currency, even then the reduction of her international purchasing power might have caused a fall in world prices. As it was, a number of raw-material producing countries followed Great Britain in the depreciation of her currency. They were thus in a position to sell to Great Britain more cheaply than were the countries whose currencies did not depreciate. For this reason the commodity prices within the Sterling Bloc dictated the tendency of the commodity prices outside the Sterling Bloc. The United States, on the other hand, is both a large consumer and a large producer of raw materials. Given the fact that she pursued a policy of raising commodity prices, the important place she occupies both as a producer and as a consumer enabled her to influence world prices in the upward direction. The main source of difference is the different monetary policy pursued by Great Britain and the United States after the suspension of the gold standard. The British Government did its utmost to prevent a rise in commodity prices, while the United States Government did its utmost to cause a rise. This itself would be sufficient to account for the difference in the results.

Although President Roosevelt did his utmost to stimulate the rise in commodity prices by an inflationary monetary policy and by his general economic policy, the rise remained, none the less, inferior to the depreciation of the dollar, and consequently further deflation in countries of the gold group became inevitable. For this reason, the countries of the gold group did not share in the trade revival caused by the depreciation of the dollar in countries with depreciated currencies.

(6) The Turning-Point

It may be said without fear of contradiction that the suspension of the gold standard in the United States provided the turning-point in the world crisis. Admittedly, there was some slight recovery early in 1931 and again during the third quarter of 1932. On both occasions, however, the recovery proved to be limited and short-lived. In 1932, the slight rise in commodity prices during the third quarter was followed by

a relapse towards the end of the year, and in most countries price levels reached their lowest point about March 1933. From that time onwards, there was a general rise which was accompanied by a marked decline in unemployment. With the exception of the countries of the Gold Bloc, and apart from the inevitable temporary relapses, the improvement was maintained and even accentuated throughout 1934 and still continues at the time of writing.

The opponents of President Roosevelt's policy, confronted with the facts, maintain that it was sheer coincidence that world trade should begin to recover from March 1933. In reality, President Roosevelt is entitled to claim the full credit for any improvement within and outside the United States since his advent. He was the first to adopt a policy of active intervention to end the crisis. The policy of France and the other countries of the gold group was purely negative. It consisted in defending their currencies at all costs, and allowing the crisis to run its course. The British policy was also largely passive. It consisted in making money cheap, and hoping for the best that cheap money would work miracles. President Roosevelt, on the other hand, took drastic steps to raise the level of prices by means of causing the dollar to depreciate, by means of large public expenditure, and by means of the policy adopted by the National Recovery Administration aiming at raising the purchasing power of consumers. Unquestionably he made innumerable mistakes. Indeed, it may be said that more often than not he did the right thing in the wrong way. Owing to his hesitation and half-heartedness and his frequent changes of policy, the recovery he produced remained comparatively moderate. Notwithstanding this, it is impossible to deny his immense merits in breaking the international economic deadlock by his policy of action.

CHAPTER XXXII

DOLLAR'S SUPREMACY

(1) Eclipse of Sterling as World Factor

From the moment of the suspension of the gold standard in the United States, sterling had to relinquish the key position it had occupied in international finance since September 1931. It was no longer the movements of sterling and the policy of the British Government that determined international tendencies. Although sterling still retained an important position among world factors, from April 1933 it had to be satisfied with the second place behind the dollar. Even after the provisional stabilisation of the dollar in January 1934, world tendencies remained under the influence of American monetary policy rather than under that of the fluctuation of sterling. The initiative was taken by President Roosevelt.

It is true that sterling represented the whole weight of the Sterling Bloc, which was at least equal to the tremendous economic weight of the United States. As, however, the British Government did not pursue an active policy, President Roosevelt was placed in a position of dictating the pace.

At the time of the suspension of the gold standard in the United States, it was believed that this move, which took the British authorities completely by surprise, would lead to a currency depreciation race between Great Britain and the United States. Those who held such views, however, overlooked the essentially orthodox mentality of British statesmen who never aimed at a depreciation of sterling beyond a degree that they considered absolutely indispensable. While they were vaguely in favour of higher commodity prices, they never had the courage of their convictions to take any deliberate steps to attain that end. But for President Roosevelt's policy, they would probably have stabilised sterling sooner or later at a level which would have precluded any material rise in prices.

(2) No Currency Depreciation Race

After the suspension of the gold standard by the United States, Great Britain adopted a policy of " expectant hesi-

tancy ". There was some degree of *rapprochement* with France, as a result of which a sterling credit was granted by British bankers to the French Treasury to tide the latter over its difficulties, and facilitate the task of supporting the franc. The dollar was allowed to appreciate in terms of sterling without the least effort on the part of the British authorities to prevent the movement. It was not until the sterling-dollar rate returned to the vicinity of the old parity that the British authorities began to think of allowing sterling to move with the dollar. Even then nothing was actually done for a long time in order to prevent a further depreciation of the dollar against sterling and the rate at one time rose to 5·50 in the autumn of 1933. Evidently there was no trace of a currency depreciation race. It was only with the utmost reluctance that the British authorities allowed sterling to follow the dollar. On at least one occasion the Government was toying with the idea of linking sterling with the Gold Bloc, and it was probably only through strong opposition on the part of the Dominions that the idea was dropped. It is interesting to follow the changes during recent years in the international financial balance of power. Since the war until about 1928 the supremacy of the United States in the sphere of world finance was incontestable. From 1928 onwards, when the Wall Street boom began to get out of control, American monetary policy as an active factor declined in importance. At the same time, the influence of the French monetary policy was rising rapidly. Until September 1931 all eyes were directed towards Paris to see what France's next move would be. The suspension of the gold standard in Great Britain changed the situation. Between September 1931 and April 1933, London was the centre of the financial universe. From April 1933 onwards, however, everybody concerned with international finance was watching Washington's next move. It was known that President Roosevelt was in favour of depreciation of the dollar. The question was how far he wanted to go. The countries which remained on a gold basis regarded the depreciation of the dollar with growing uneasiness. They would have liked to see the dollar re-stabilised at the earliest possible moment and at the highest possible level. These sentiments were shared by the British Government, notwithstanding the fact that Great Britain was in a position to benefit to a large degree by President Roosevelt's policy.

(3) The World Economic Conference

It was with the object of arriving at some agreement about stabilisation that the World Economic Conference was organised in London during the summer of 1933. Although the conference covered a wide range outside the sphere of currency problems, its success evidently depended upon the possibility of arranging some kind of *de facto* stabilisation. It was equally evident that the success of the attempt depended upon the attitude of the three leading countries, the United States, Great Britain and France. For this reason, the negotiations which were being carried on at the Bank of England and at the Treasury between the financial experts of these three countries were of far greater importance than the discussions of the official conference at the Geological Museum in South Kensington. It was hoped on the French side that it would be possible to obtain the preliminary stabilisation of the currencies for the period of the Economic Conference. The idea was not altogether unreasonable since evidently it was not easy to take decisions about economic questions while the dollar was undergoing a depreciation and was subject to violent fluctuations, and while its definite level remained uncertain.

At the same time, it was obvious that in June 1933 the dollar had not yet reached the level at which President Roosevelt could possibly have been prepared to stabilise it. In the circumstances, the attempt at an understanding was hopelessly premature and was doomed to failure. Notwithstanding this, the unofficial conference seems to have made unexpectedly good progress at the beginning, and an understanding of a purely informal character was reached for the pre-stabilisation of sterling and the dollar during the conference. According to this so-called "gentlemen's agreement", the United States authorities were prepared to keep the dollar somewhere around 4·05 but reserved to themselves the right to discontinue the arrangement at a moment's notice.

(4) President Roosevelt's Attitude

This arrangement failed, however, to obtain President Roosevelt's approval. Whether it was because the negotiators, under the influence of the international atmosphere of the conference, exceeded their rather vague instructions, or whether it was because as a result of the relapse in commodities and securities caused by the mere unofficial report of this informal agreement that President Roosevelt changed his mind, is a matter of detail

from the point of view of history. The fact remains that the President vetoed the arrangement so as to reassure the American public that he would continue his inflationary policy. Notwithstanding this, it might have been possible to carry out the understanding even in the absence of any definite undertaking to that effect but for the insistence of France and the Gold Bloc countries upon an understanding of a more definite character. The delegates of the gold countries considered it imperative to obtain a binding undertaking from the United States so as to restore confidence in their currencies which, at the time, were subject to bear attacks. The Dutch Government was particularly insistent since the bear attack was mainly directed against the florin.

Their insistence upon a decision was largely responsible for President Roosevelt's emphatic note to the conference on July 3, in which he made it quite plain that he had not the least intention of committing himself to any stabilisation whatsoever. Indeed, the terms of the note allowed it to be understood that President Roosevelt was inclined to question the wisdom of ever returning to the gold standard in its old form. The tone and contents of the note exasperated the delegates of the gold countries to such an extent that they decided to retaliate by wrecking the conference. Although the attitude of Great Britain in trying to conciliate the extreme views actually saved the conference from breaking down, the negotiations during the subsequent weeks amounted to little more than an attempt to save its face and keep up appearances. In the absence of any common ground for an agreement on stabilisation, there was no hope for any agreement on any important question.

(5) Gold Bloc and Sterling Bloc

While the conference was thus marking time so as to be able to adjourn without making it unduly obvious that it had failed, the conference groups of participants were doing their utmost to consolidate their position. The countries on a gold basis signed a joint manifesto announcing the creation of the Gold Bloc and declaring their determination to defend their currencies at the existing parities to the utmost. They left no stone unturned to induce the British Government to stabilise sterling, but any inclination in that direction was nipped in the bud by the determined attitude of the British Dominions to prevent such a decision. It was evidently against the interest of agricultural countries such as Canada, Australia, New Zea-

land and India to stabilise their currencies while the dollar was depreciating. Had the British Government decided to stabilise sterling, in all probability the Dominions would have followed the dollar.

Whether or not the idea of stabilisation was seriously considered, the attitude of the Dominions induced the British Government to reassert the monetary principles expressed in the Ottawa Declaration in 1932, and thus to consolidate the Sterling Bloc.

As a result of the declaration of the solidarity of the Gold Bloc, the run on the florin and other gold currencies ceased. At the same time, the anticipation that sterling would now follow the dollar resulted in a persistent selling pressure on sterling. The Exchange Equalisation Account resisted this selling pressure for some time, maintaining sterling at 86 francs. When, however, seasonal influences accentuated the pressure on sterling, the authorities decided not to use up any more of their gold stock, and allowed sterling to depreciate. Although in the late autumn, flight from the dollar and the franc resulted in a recovery, in the course of 1934 sterling gradually adjusted itself to the dollar on the basis of the old parity.

It was towards the end of 1933 and the beginning of 1934 that the supremacy of American monetary policy in world finance made itself felt in the most emphatic and aggressive manner. The gold-buying policy adopted by President Roosevelt in October 1933 constituted an act of deliberate currency depreciation without precedent. Its substance was that the United States authorities were prepared to buy gold above its world market price. Even though during the earlier period of the application of this new policy the extent to which actual gold purchases were made abroad was limited, its psychological effect was tremendous. It was thought for a time that President Roosevelt's gold policy might drive the countries of the Gold Bloc off the gold standard. Indeed, the flight from the franc towards the turn of the year was largely the result of such fears. Had President Roosevelt not stabilised the dollar provisionally at the end of January 1934, the pressure caused by his gold-buying policy upon the Gold Bloc would probably have accentuated the French crisis and might have produced fatal results. There can be no doubt that it was this drastic and brutal intervention in world finance by the United States that induced the British Government to discard definitely any idea of *rapprochement* with the Gold Bloc and to adopt definitely the policy of adjusting sterling to the dollar.

The brutality of the gold-buying policy was subject to much criticism even on the part of those who were otherwise inclined to approve of President Roosevelt's policy. It ought to be remembered, however, that it is only by such drastic action that any spell of economic and financial deadlock can be broken. The deadlock in which every party is waiting for the other to make a move and nothing happens can best be compared with trench warfare, compared with the monotony and futility of which a vigorous attack was a refreshing change. There was no other means of causing the dollar to depreciate to the desired level, and this in itself justified President Roosevelt's action.

The victory of the American influence over the influence of both sterling and the Gold Bloc was an evidence of the predominant position of the dollar since the suspension of the gold standard. Much more important evidence of the dollar's supremacy was the change in the trend of world prices brought about by President Roosevelt's policy. About the circumstances and details of the American policy which tended to raise prices we propose to say more in the fourth part of this book covering the period of reflation. This period largely overlaps that of deflation, since simultaneously with the policy of reflation in the United States and its effects upon the sterling group, the gold group and its satellites continued to deflate. Indeed, to a large extent the deflation in the gold countries counteracted the effect of reflation in the countries with depreciated currencies.

CHAPTER XXXIII

FRANCE'S CRISIS

(1) Gold Standard—Real and Fictitious

While the United States and the countries of the Sterling Bloc enjoyed the benefits of economic recovery and internal financial stability brought about by the depreciation of their currencies, the countries of the Gold Bloc underwent a depression of increasing severity. The depreciation of sterling and dollar was accompanied by a further decline of commodity prices in the countries of the Gold Bloc. This in turn was accompanied by all the unfavourable effects that usually go with a falling price level, such as the increase of unemployment, difficulties of industrial and commercial firms, budgetary difficulties, and in some cases, political troubles.

In the circumstances, it is not surprising that a number of countries which survived the depreciation of sterling in 1931 gradually drifted apart from gold in the following two years. While nominally they retained their old parities, in practice their currencies underwent a more or less disguised depreciation. In the case of Germany, Austria, Hungary, Roumania, Jugoslavia, etc., only a fraction of the transactions were based on the official exchange rate, while the rest were carried on either through the "black bourses" where the national currencies depreciated, or with the aid of various special currencies which stood at a substantial discount against the official rate. In all these countries the existence of the gold standard was purely fictitious, and their claim to have retained their parities was sheer hypocrisy. Austria went so far as to legalise the depreciation of the shilling which took place at the unofficial market, while Czechoslovakia carried out officially a 16 per cent devaluation.

The number of countries which continued to adhere rigidly to their old parities throughout the depression was very small. The gold group which was formed officially during the Economic Conference consisted of France, Italy, Belgium, Luxemburg, Holland, Switzerland and Poland. It was these countries which had to bear the main burden of the depression.

(2) France's Strong Position

The experience of France between 1931 and 1934 provides a characteristic example of the effects of deflation. If ever there was a country which entered the phase of deflation with the maximum of resisting capacity, it was France. As a result of a series of prosperous years, her Treasury, her Central Bank, her commercial and industrial banks and her industrial and commercial enterprise in general were strong and liquid, well prepared to face the lean years. To a large extent, France was thought to be economically and financially self-supporting. The degree of her dependence upon prosperity abroad was probably smaller than that of any other country of importance. The extent to which her banks had committed themselves in Central Europe was relatively small. In France, prosperity between 1927 and 1929 did not degenerate into a speculative boom. Above all, at the beginning of the crisis both wholesale prices and the cost of living in France were still considerably below the world level, thanks to the under-valuation of the franc in 1928. Thus, the fall of world prices, or alternatively, the depreciation of other currencies had to go some way before the advantages obtained by France through the act of under-valuation were cancelled out.

Indeed, it appeared until September 1931 as though France would remain practically immune from the world crisis. The extent of her unemployment was negligible. Trade was reasonably prosperous and apart from some isolated bank failures due to local and individual causes, the country did not experience any noteworthy difficulties. Although French exports of luxury articles suffered as a result of the world-wide depression, the extent to which this adverse factor influenced the general situation was not excessive.

(3) The Turning-Point

The suspension of the gold standard in Great Britain became the turning-point in the evolution of the economic crisis in France. As a result of the depreciation of sterling and a number of other currencies, the franc became over-valued instead of being under-valued. The result was a deterioration of the trade balance, notwithstanding the measures taken for reducing imports. In consequence of the depreciation of sterling and other currencies, the decline of world prices became accentuated, and France did not remain immune from this trend. In spite of the special measures taken to bolster up the

price of wheat and wine, and in spite of customs tariffs and quotas, commodity prices fell steadily in France. This again made it impossible for the Government to balance the budget. The increasing budgetary deficit and the support granted to various banks exhausted the Treasury's surplus. The losses and immobilisation caused by the prolonged crisis made heavy inroads into the reserves of the banks. Not long after the suspension of the gold standard in Great Britain, France was in the throes of a crisis to the same extent as most other countries.

At the beginning, the French authorities appeared to be satisfied with the deflationary developments. They seized every opportunity to declare themselves emphatically in favour of deflation. It was their declared policy to solve their difficulties by cutting costs and prices to the utmost, and they registered with satisfaction every progress made in that direction. To some extent this may have been a case of making a virtue of a necessity, but to a large extent, doubtless, this was in accordance with the fundamental characteristics of French mentality. *La vie chère* inspires Frenchmen with horror, and any reduction of prices is bound to be popular, at any rate so long as the repercussions of such reduction are not realised. Before very long, the majority of Frenchmen had to realise, however, that even *la vie chère* was to be preferred to a reduction of prices in the circumstances in which it took place between 1931 and 1934. The fall of prices did not bring the happiness that was expected. Far from it. Conditions changed from bad to worse with every new fall of prices. Profits declined and disappeared and the reserves accumulated during the period of prosperity dwindled down. The losses suffered by banks provoked a wave of distrust and the ensuing run resulted in a series of bank failures, even though the more important banks affected by the run were saved by Government support. The budget had been hopelessly unbalanced ever since 1930. Revenue was falling and amidst the crisis it was impossible to create new resources. The reduction of expenditure met with the utmost resistance on the part of Parliament and of the Civil Service. Year after year there was a deficit running into milliards, and the market showed itself increasingly unwilling to absorb new Government loans. The difficulty of raising the funds required for the current deficit and for maturities, resulted in a crisis of the Treasury from time to time. At times the Treasury's balance with the Bank of France declined below one hundred million francs, which was barely sufficient to cover a few days' current requirements.

(4) Fears of Inflation

It was feared that sooner or later the inadequate cash supplies of the Treasury would lead to inflationary borrowing from the Bank of France. Hence the flight from the franc which took place from time to time in spite of the huge gold reserve of the Bank of France. The outward movement of French funds was accentuated by the flight of foreign funds which took refuge in Paris. France had to realise that to play the part of an international banking centre has its disadvantages which at times more than offset its advantages. While countries such as Italy which never attracted foreign funds to any extent were not exposed to the shocks caused by foreign withdrawals, from time to time France had to face a heavy outflow of foreign balances. It is true that the Bank of France could well afford to lose gold. Nevertheless, whenever there was a persistent outflow of gold, the French public became alarmed, and resorted to hoarding or to the transfer of capital abroad. The psychological factor was of greater importance in France than in almost any other country.

The crisis attained its climax at the beginning of 1934. A series of financial scandals culminating in the notorious Stavisky affair, brought about a *crise de confiance* of unprecedented dimensions, and demoralised the country to an extreme degree. The public was beginning to lose faith in Government and Parliament, since they were evidently unable or unwilling to tackle the financial problems. There were frequent street riots, which threatened to assume a revolutionary character in February 1934. There was a wholesale flight of capital from France, and the Bank of France was losing gold heavily. It appeared at one time as though the collapse of the franc was inevitable.

The advent of the Government of National Union under M. Doumergue and the serious efforts of M. Germain Martin, the Finance Minister, to balance the budget, restored confidence to a large extent. Indeed, on paper the budget appeared to be balanced with the aid of drastic economies amounting to something like four milliard francs. The Treasury's crisis was overcome with the aid of a short-term credit raised in Holland. Although the terms of this credit were humiliating, it certainly provided a much-needed breathing space for the Treasury until the economy measures had produced their result. The flow of gold became reversed, and by September the Bank of France had recovered all it had lost.

(5) Deflationary Effect of Economies

For some time France was under the impression that her budget was actually balanced. It was admitted that the railway budget still had a deficit in spite of the economies, and that there were certain items of expenditure which were not included in the ordinary budget. But apart from this it was believed that the budgetary problem was solved. Those who believed this, however, overlooked the deflationary effect of economies. They failed to realise that by cutting down expenditure the Government was reducing purchasing power, and that in doing so it was bound to aggravate the economic depression. This is exactly what occurred during 1934. All the indices of business activity pointed towards an increase of the depression. There was a further fall in commodity prices, a further increase in unemployment, and a further decline in the index of production, in railway receipts, etc. In the circumstances, it was inevitable that budgetary revenue should also decline. Although in the autumn the Government resorted to the time-honoured device of balancing the budget on paper, it was evident that the deficit in 1935 would attain a record figure. Together with the railway deficit and with the items excluded from the budget, it was estimated at something like twelve milliard francs.

Deflation in France attained a degree by the end of 1934 at which it was bound to defeat its object. Any further deflation would evidently have increased further the budgetary deficit, and would have made it increasingly difficult for the Treasury to cover its requirements. It was to be expected that sooner or later France would have to inflate to meet her Treasury's requirements. This was apparently realised by the new French Government that succeeded M. Doumergue in November 1934, and M. Flandin made virtue out of necessity, by declaring himself against further deflation. Two months later, he adopted a reflationary policy which we propose to examine in Part IV of this book.

(6) Deflation in Other Gold Countries

The example of France has conclusively proved the impossibility of deflating *ad infinitum*. Nor was France the only example to prove that deflation has arithmetical limits. There was also the case of Belgium. She under-valued her currency to an even larger extent than France, and for years her price level was easily the lowest of all civilised countries. The prolonged fall in prices and the depreciation of currencies wiped

out her advantages and placed her industries at a grave disadvantage. As Belgium depends upon foreign trade to a much larger extent than France, and her exports have to face British and American competition to a much larger extent than those of France, she was affected by the international currency situation to a much larger extent. Efforts to cut wages met with violent resistance, and the Government had to assume dictatorial powers to cope with the emergency. A strong movement in favour of devaluation developed among industrial and commercial interests, and from time to time the belga was exposed to a heavy flight of the national capital.

In Holland, too, deflationary measures led to riots and the machine gun had to be added to the weapons of deflationary policy. The Dutch colonies suffered through the depression to a very high degree, and since the prosperity of the mother country depends largely upon that of its colonies, in many ways Holland was affected by the depression to a larger extent than the other countries of the Gold Bloc.

In Switzerland it proved to be impossible to reduce the cost of living sufficiently to make the country attractive for tourists. The competition of countries with depreciated currencies, such as Austria or Germany, diverted much tourist traffic from the country. Owing to its dependence upon this source of revenue, this caused an acute depression which resulted in the failure of several banks of secondary importance. In Switzerland, too, there was a strong movement in favour of devaluation.

(7) Deflation in Italy

The advent of the crisis found Italian trade in a depressed state. Owing to the over-valuation of the lira, a number of large industrial and commercial firms and banks had already got into trouble before the beginning of the world crisis. The Government came to the assistance of the leading banks, whose resources became immobilised as a result of the fall in security and commodity prices. Special institutions were created for the purpose of relieving the banks from their industrial assets. Thanks to the existence of a remarkable degree of economic discipline, it was possible to adjust prices, cost of living and wages in a downward direction with less difficulty than in most other countries. On two occasions an all-round cut of something like 10 per cent was carried out, affecting salaries, wages, rents, etc. Although the Government spent large amounts on productive public works, it succeeded in avoiding inflation. As a result of the increase in wheat production, Italy managed to

increase her self-sufficiency. Notwithstanding all this, she had to suffer a great deal through the depression.

Italy departed to some extent from rigid deflation with the result that during 1934 the volume of her production increased but domestic commodity prices failed to follow the decline of those prevailing in other gold countries. As a result, the import surplus increased, and there was a heavy outflow of gold, which towards the end of 1934 threatened to affect the stability of the lira. It was only by seizing privately owned foreign assets that the stability of the lira was further maintained.

(8) Co-operation Within the Gold Bloc

The efforts to establish closer co-operation between the countries of the Gold Bloc so as to facilitate the defence of their currencies have produced very little practical result. There was no question of any pooling of their gold resources or of any reciprocal financial support. Such actual assistance as was given did not exceed the limits of technical co-operation which also exists between Central Banks outside the Gold Bloc. Thus, the lira was supported in Paris by the Bank of France, but the resources required for the support were supplied by the Bank of Italy. From time to time, there was a flow of gold to Paris from the other countries of the Gold Bloc and the French authorities did nothing to check the movement which was embarrassing for the Central Banks concerned.

It was hoped to increase trade between countries of the Gold Bloc following the example of the Sterling Bloc. In fact, the Brussels Conference held in October 1934 passed a resolution that within the next twelve months the countries of the Gold Bloc should conclude agreements tending to increase their reciprocal trade by 10 per cent. Up to the time of writing, however, little or nothing has been done to put this resolution into practice.

It was in such circumstances that the countries of the Gold Bloc arrived at the conclusion towards the end of 1934 that they would cease to deflate any further. Instead, they decided to await developments in the United States, in the hope that a recovery of world prices would remedy the disequilibrium from which they were suffering.

CHAPTER XXXIV

THE SILVER DEFLATION

(1) Silver Before, During and After the War

The story of the great deflation of 1929–34 would be incomplete without devoting a chapter to the question of silver. It is one of the most highly controversial questions in a period which certainly cannot complain of lack of controversial material. Both in the United States and in this country the silver problem has become the subject of a violent conflict of opinion, in the course of which the parties have been fighting with unusual bitterness.

As is well known, silver had become almost completely demonetised before the war in the greater part of the civilised world. After having been the principal monetary metal for many centuries, it had become a secondary metal for subsidiary coins and token money in Europe and on the other continents, apart from financially undeveloped countries, such as China or India. Although from time to time efforts were made, especially in the United States, to arouse public opinion in favour of a remonetisation of silver, the bimetallist movement was practically non-existent by 1914. Gold definitely took the place of silver as the monetary metal of financially advanced countries, even though silver remained the monetary metal in the greater part of Asia and Africa.

During and after the war, silver behaved exactly as if it were an ordinary commodity ; its price moved more or less in sympathy with commodity prices. During the post-war boom it rose to a record level, and its rise was followed by an equally heavy fall during the post-war slump. Largely owing to the instability of silver in terms of gold, the British Government decided to demonetise silver in India and to replace it by the gold-exchange standard. This move inevitably brought about a fall in the price of silver. Apart from selling by the British Indian authorities, who were anxious to liquidate their stock of silver coins, the weak tendency of silver was also due to fears that it might eventually be demonetised completely. Persia, Siam and several other countries followed the example of India by deciding to change over from silver to gold.

(2) Silver and China

Even China was flirting with the idea, and if her Government did not follow Professor Kemmerer's advice to that effect, it was merely because the acquisition of a sufficiently large amount of gold reserve would have been difficult, since it would have been impossible to sell a large amount of silver without depreciating its value considerably, or to raise a large external loan. It is somewhat difficult to imagine how the learned adviser of China expected to dispose of the country's silver stock without inflicting heavy losses upon its holders.

During the international crisis, the price of silver continued to fall in terms of gold currencies in accordance with the tendency of commodity prices. For this very reason, however, silver remained comparatively stable in terms of commodities. Thanks to this, China and a few other silver-using countries escaped the worst of the depression caused by the fall of commodity prices in terms of gold. At the same time her purchasing power abroad inevitably declined owing to the depreciation of her currency in terms of the gold currencies. This provided an additional factor for the accentuation of difficulties in countries exporting to China, but for China herself it was a highly satisfactory state of affairs. It was thanks to the absence of deflation that, notwithstanding internal disorders and wars with Japan, economic conditions in China remained comparatively satisfactory until 1934.

Gratifying as this state of affairs may have appeared to the Chinese people themselves, it was considered highly unsatisfactory by many people abroad. Since 1931 a number of experts and pseudo-experts had carried on an agitation for the remonetisation of silver. The old arguments in favour of bimetallism were revived, and the Nineteenth-Century controversy was raging once more over the white metal.

(3) "Altruistic" Bimetallists

That amidst a crisis caused by the scarcity of gold, there should be a movement favouring the remonetisation of silver is not at all surprising. What is somewhat strange is that the main argument of the champions of bimetallism was that it was desirable from the point of view of the Chinese people themselves to raise the value of the metal which constituted the basis of their currency. Impassioned appeals were addressed to the world, demanding in the name of justice and equity the revaluation of silver for the sake of the poor destitute Chinese

people. It was pointed out that since so many hundreds of millions of souls in Asia, Africa and elsewhere were still on a silver basis, in all fairness to them silver ought to be restored to its old value in relation to gold.

This campaign to save the Chinese by revaluing silver bears a faint resemblance to the campaigns to save the Armenians from the Turks during the decades that preceded the war. It will be remembered that the pro-Armenian campaign resulted in the almost complete extermination of that unfortunate race, and even though the silver campaign could not be expected to produce such tragic results, its partial success in the United States certainly dealt a heavy blow to China.

While the demonetisation of silver in accordance with Professor Kemmerer's advice would have hit the hoarding classes, the increase of its value inevitably affected adversely the Chinese producers and merchants, whose commodities fell in terms of silver. It was indeed a doubtful blessing for which the Chinese population has no reason to be particularly thankful.

(4) American Silver Policy

Thanks to the political influence of the silver-producing States, the United States Administration decided in 1934 to yield to their pressure by adopting a policy aiming at the partial remonetisation of silver and the increase of its price. While silver was not admitted on an equal footing with gold, it was made eligible to serve as a subsidiary metallic cover to the extent of 25 per cent of the total.

The silver-purchasing policy of the United States resulted in a sharp recovery in the price of silver. This has been convenient to American, Indian and other holders of silver stocks, who were thus enabled to unload at comparatively favourable prices, but it proved to be a doubtful blessing for China and for other countries where silver was the monetary metal. The rise in the value of silver brought about a fall in commodity prices in the silver-using countries; the latter at last began to enjoy the blessings of deflation, which they were spared, thanks to the fall in silver, until 1934. At the same time, the attractive price of silver induced many Chinese holders to sell their holdings abroad. There was a heavy outflow of silver from China, which depleted to a large extent the supply of currency of the country. Thus, in addition to its automatic effect upon Chinese commodity prices, the American silver policy produced deflation in China also through bringing about a restriction in the supply of currency. Under these dual influences, a crisis

of considerable intensity developed in China towards the end of 1934. At the beginning of 1935 several Chinese banks suspended payment.

(5) Chinese Government's Measures

The Chinese Government, in order to check the deflationary effect of the American silver policy, introduced an export tax on silver which varies according to the difference between the price in China and in the world market. In theory the result of this measure should be to make it unprofitable to export silver from China, since whenever the discrepancy between its internal and external price increases, the export tax is increased accordingly. In practice, however, the outflow of silver continued partly because of the immense possibilities of smuggling, and partly because holders were prepared to export even at an apparent loss for fear of the Chinese Government's measures, and by the beginning of 1935 the situation was becoming critical. It is conceivable that the Government will take drastic steps to meet the emergency, either by devaluing the dollar or possibly by abandoning the silver standard and adopting the gold standard. Should this latter step be taken, it would become very difficult for the American authorities to maintain the price of silver in face of heavy selling.

While there is much to be said in favour of adding silver to gold as a basis for currency, there is no reason why the price of silver should be raised artificially for that purpose. The more it is raised, the more difficult it will prove to maintain a fixed parity between gold and silver. Apart altogether from the attitude of China, if silver is over-valued in terms of gold there will be a natural trend everywhere to unload silver, and production will also increase considerably. The monetary authorities who are prepared to maintain a fixed ratio between silver and gold will be offered rather more silver than they want. If those who advocate the remonetisation of silver did not advocate at the same time a considerable increase in its value, their propaganda would probably be much more effective.

CHAPTER XXXV

THE END OF REPARATIONS

(1) Optimism of the Young Committee

If the depression of 1929–34 had one favourable effect it was that it compelled the world's statesmen to face realities about the political indebtedness inherited from the war. We have seen in an earlier chapter that this political indebtedness was largely responsible for the disastrous inflation in Central Europe; that its existence rendered the attempt at stabilisation precarious; that directly or indirectly it stimulated the development of factors which led to the crisis; and that hesitation about their settlement during the crisis was largely responsible for the accentuation and prolongation of the troubles.

At the beginning of 1930 the statesmen and economic experts of the nations were entirely oblivious to the fundamental nature and sweeping extent of the crisis which had then just begun. At The Hague they concluded an agreement in January 1930, which was based on the recommendations of the Young Committee. These recommendations reckoned Germany's capacity to pay as it may have appeared to an optimist early in 1929 on the assumption that prosperity would continue and increase during the following decades. Apparently, the Wall Street slump in itself was not sufficient to make the world realise the futility of fixing reparations payments on such optimistic assumptions. Of all those responsible for the drafting of the Young Report, Dr. Schacht alone had the courage to repudiate his signature, and even he was right for the wrong reason. It was not the comparatively small amount of additional burden of the special Belgian claim, and a few other items which induced Dr. Schacht to resign rather than sign, that rendered the Young Plan impracticable. It was the fundamental turn in the tide introduced by the Wall Street slump that would have justified a change of opinion about Germany's capacity to pay.

Even if the figures of the Young Report had represented Germany's capacity to pay, such as it was early in 1929, the necessity of revising those figures should have been obvious

after the Wall Street slump. In reality, the figures of the Young Report were excessively high even for pre-slump conditions. The report was the result of a political compromise, and was adopted after the Wall Street slump, either because the significance of the change was not realised, or simply because it would have been too much trouble to re-open the whole question again.

(2) Borrowing and Reparations

Germany undertook at The Hague once more to pay a good deal more than she could afford. In itself, this fact would not have brought matters to a head. After all, ever since the Armistice, Germany had been paying more than she could afford. Until 1923 she financed reparations payments by selling mark notes to foreign speculators who were foolish enough to believe in the ultimate recovery of the German currency. Between 1924 and 1929, the reparations payments were financed by foreign lending to Germany. From that time onward, however, with the virtual cessation of German long-term issues abroad, the only way to finance reparations was through the increase of foreign short-term indebtedness. The result was the development of a highly dangerous situation which increased the probability of a crisis, and increased the gravity of the crisis when it occurred. But for The Hague Agreement, the volume of German short-term indebtedness in the summer of 1931 might have been considerably smaller.

It is true that The Hague Conference made a constructive effort in establishing the Bank for International Settlements. Had the bank fulfilled the expectations of one of its authors, Sir Josiah Stamp, who hoped that it would provide the means for counteracting deflation, and even for raising world prices, it would have gone a long way towards facilitating the execution of the reparations clauses of the Young Plan. Unfortunately, the bank had no time to develop sufficiently to become really useful, and even if it had had time to develop, the chances are that deflationary French influence would have prevailed in its policy.

(3) Reparations and the Crisis

Reparations were not directly responsible for the Central European crisis of 1931. While in 1923 they were the direct cause of the financial collapse of Germany, eight years later they were merely a contributory factor. They accentuated the wave of distrust by their very existence in the background when the

run on Central Europe began. Indeed, in June 1931 an effort was made to obviate a collapse by removing temporarily the burden of reparations. Europe and the whole world owes a debt of gratitude to the United States for President Hoover's magnificent gesture in offering a twelve months' complete moratorium in war debts and reparations. This gesture has gone a long way towards condoning the previous and subsequent attitude of the United States in the matter of war debts. We pointed out before that the Hoover moratorium failed to produce the effect that was expected of it, because it was not long enough, and because its adoption was subject to hard bargaining which foreshadowed future troubles. Its adoption failed to check the run on Germany and failed to obviate the German crisis, culminating in the moratorium on short-term credits. Notwithstanding this, taking a long view, the significance of the Hoover moratorium was immense. It effectively broke the deadlock of political indebtedness. Without it, France would have insisted upon reparations payments throughout the crisis, and under the menace of another Ruhr occupation, Germany would probably have suspended completely the service of her external commercial debts in order to pay reparations debts so long as there was any gold left in the Reichsbank. It is true that by 1934 the service of her commercial debt was in any case almost completely suspended. But the breathing-space of three years was most valuable to the creditors. If Germany's wholesale default had been committed in 1931 instead of 1934 it would have aggravated the financial crisis beyond measure. In the meantime, banks, insurance companies, and many private investors, succeeded in reducing considerably their German commitments, and were in any case in a better position to withstand the blow. For this reason alone, the world owes a great debt of gratitude to President Hoover for his magnanimous gesture. Even though he failed to prevent the crisis, he certainly moderated its disastrous consequences.

There is another aspect of the Hoover moratorium which ought to be borne in mind. It was much easier for both Germany and the Allied debtors to abstain from resuming payment once payment was suspended by the consent of the creditors than to take the initiative in suspending payment by unilateral default. But for the Hoover moratorium, the world would probably have continued to struggle on with the payment on its political indebtedness until a general financial collapse had put an end to its efforts.

(4) A Short-Sighted Attitude

Those who in 1931 anticipated fresh trouble on account of reparations in spite of the Hoover moratorium were of course not far wrong. Throughout the second half of 1931 and at the beginning of 1932 controversy was raging as to whether or not reparations had the prior claim on Germany's resources available for transfer. The uncompromising attitude adopted in this respect by the French Government was largely responsible for the world-wide pessimism about a recovery in Europe. It was feared that once the Hoover moratorium had expired, the insistence of France upon the payment would complete the work of destruction.

While perhaps it would have been too much to expect statesmen early in 1930 to see how the depression was to affect Germany's capacity to pay, there was absolutely no excuse two years later for refusing to take into consideration what actually happened between 1930 and 1932. And yet M. Laval hoped that it would be possible once more to uphold the fiction of a huge reparations indebtedness. He insisted on the postponement of the Lausanne Conference from January to June in the hope that five months later France might stand a better chance of obtaining British support for compelling Germany to sign once more something she was obviously neither able nor willing to fulfil. It was this postponement of the Lausanne Conference which was responsible for the fall of the Government of Dr. Brüning, and for the advent seven months later of Herr Hitler. Had the concessions made by France to Germany at Lausanne in June 1932 been made five months earlier, history might have taken a totally different turn. There might have been a genuine Franco-German reconciliation, which would have produced a right psychological atmosphere for a recovery.

(5) After the Lausanne Agreement

At Lausanne an agreement was at last concluded in which reparations were reduced to a reasonable figure. It would of course have been better for all parties concerned if reparations had been wiped out altogether. In any case, the French Government was well aware that Germany would never pay even the relatively modest amount fixed at Lausanne. It had to pretend to expect payments, however, in order to satisfy French public opinion. The Lausanne agreement failed to produce the effect that might reasonably have been expected. Like the Hoover moratorium it fell hopelessly flat. In the first

place, the hard bargaining that preceded the gesture made by France eventually reduced to a minimum the good impression the agreement created. What is even more important, the agreement was subject to a drastic reduction of war debts by the United States. This was a mistake, since the result was that uncertainty as to the fate of reparations continued to exist. It was evident that immediately before or after the presidential election, President Hoover would not be in a position to make concessions. In the circumstances, it was feared that France would not ratify the Lausanne Agreement and the whole reparations problem would stand where it was before Lausanne. In reality the Lausanne Agreement was never ratified, but in spite of that reparations have gradually faded out of existence. Had this practical result been achieved by the Lausanne Agreement through the willingness of France to cancel reparations, it would have produced a highly favourable effect. As it was, reparations faded out almost imperceptibly, and the psychological effect of this highly important change was negligible.

(6) Default on War Debt

While reparations disappeared from the limelight after Lausanne, war debts became the centre of interest during the following six months. Overtures made by Allied Governments to induce President Hoover to prolong the moratorium on war debts pending a definite settlement met with no response. The president was profoundly disappointed by the negative result of his gesture of June 1931, and was not in a mood for repeating it. In any case, Congress and public opinion were violently hostile to any idea of making concessions in the matter of war debts. The exchange of notes between the debtor Governments and the Washington Administration stirred up much ill-feeling on both sides without bringing the problem nearer solution.

In the absence of any hope for an early settlement, France and several other debtors decided to default on the instalment falling due on December 15, 1932. Several debtors, Great Britain among them, decided to make the payment.

We have seen in an earlier chapter that the anticipation of the payment of the British instalment was largely responsible for the slump of the pound in November and December 1932, and that the flight to the pound which followed its exaggerated depreciation was largely responsible for the adverse pressure upon the dollar in January 1933. The insistence upon the payment of the December instalment was responsible, therefore, for the development of one of the factors which provoked the

panic in the United States, resulting in the suspension of the gold standard. There is reason to believe that the American attitude towards the end of 1932 was responsible for the panic also in another way. Until then, the Exchange Equalisation Account kept part of its resources in dollars, so that whenever it operated in order to prevent an unwanted appreciation of sterling, it supported the dollar at the same time. As, however, the Bank of England had to part with £20 millions of gold on December 15 to meet the war debt instalment, the British authorities considered it necessary to replenish their supplies by converting dollars acquired by the Exchange Equalisation Account into gold. But for the British purchases in January 1933, the outflow of gold would have been much more moderate. Considering that the big outflow was one of the causes of the panic, the change of the policy of the British authorities, brought about by the insistence of the administration upon the December instalment of war debt, was partly responsible for the suspension of the gold standard.

(7) Complete Default

When the next war debt instalment fell due on June 15, 1933, the British Government was no longer prepared to make payment in full. Together with several other Governments, it made small " token payments " which President Roosevelt was prepared to accept pending the settlement of the question. Of all the debtor countries, Finland alone continued to pay her war debts to the United States. In December 1933 another " token payment " followed, but in 1934 even that practice was discontinued. Attempts made to come to an agreement had a negative result, and by the end of 1934 war debts faded into the background, almost to the same extent as reparations.

As in the case of reparations, the liquidation of this huge item of international indebtedness took place in circumstances which reduced to a minimum its beneficial psychological effect. Had the United States been prepared at the end of 1932 to waive war debts, or at any rate to reduce them to reasonable figures, the gesture would undoubtedly have resulted in a certain amount of optimism. As it is, the fact that some of the leading countries had to default, created a bad impression and encouraged default on the part of other debtors. Nor are war debts as yet entirely out of the way. It is generally felt that the British Government, at any rate, will sooner or later conclude some kind of war debt agreement with the United States. Indeed, the British Government is not prepared to stabilise sterling

until a settlement is reached on war debts. This will of course increase the difficulties of stabilisation to no slight degree. Thus, the problem of war debts cannot be regarded as being disposed of definitely. At the same time, its significance has become reduced considerably, and it has ceased to be a major active factor in the international situation.

CHAPTER XXXVI

COMMERCIAL DEBTS AND THE CRISIS

(1) Defaults through Transfer Difficulties

THE crisis has brought about an almost complete liquidation of international political indebtedness. At the same time it has also caused a substantial reduction in international commercial indebtedness through default, repayment, or the depreciation of currencies. Since the beginning of the crisis, the majority of debtor countries have defaulted on their foreign liabilities. The existence of transfer difficulties provided an excellent excuse for this wholesale default. Before the crisis, the cause for default was usually the inability of the debtor Governments or other borrowers to provide the funds required by the debt service. Since 1931 the innumerable defaults had a totally different cause. The debtors maintained that they were able and willing to provide the means required for interest and sinking fund on their external debts, but owing to the difficulty of transferring these funds abroad, they could only provide them in the form of national currency. The Governments of the debtor countries pleaded that they did not possess a sufficient amount of gold and foreign exchange available for the requirements of external debt payments. Nor did they allow those foreign creditors who chose to accept payment in national currency instead of currencies of the contract, to dispose freely of the amounts thus obtained, for in doing so, they would have caused an increase of the selling pressure on the national currencies, which the Governments were anxious to avoid.

Thus, the amounts paid in national currency on account of external debts had to be paid into blocked accounts, and were only allowed to be employed for certain specific purposes, such as purchases of long-term bonds or real property. An immense variety of such blocked accounts have been created in various debtor countries. There were seven or eight different kinds of reichsmarks, pengos, shillings, dinars, etc., and the exchange rates of these various special currencies varied according to the extent to which they were allowed to be used. In some cases, the balances on blocked accounts were allowed to be used for

goods exports, in which cases the discount on these currencies constituted a powerful export bounty.

(2) Disguised Insolvency

In the majority of cases, the transfer moratoria on the service of foreign debts merely disguised the fact of the insolvency of debtors. Although it was true that even if the debtors had been able to pay, in the absence of adequate foreign exchange resources they would not have been in a position to transfer their payments, it was equally true that if by some miracle the foreign exchange resources had been provided, many of the debtors would nevertheless have been unable to pay. The various standstill agreements shielded solvent and insolvent debtors alike, since only comparatively few creditors availed themselves of their right to claim payments in blocked national currencies. As far as the debtor Governments themselves were concerned, the payment of the non-transferable part of their debt service into blocked accounts was sheer make-believe. There was nothing to prevent them from re-borrowing an equivalent amount from the Central Banks. Thus, the idea that the amounts which were paid into such blocked accounts were held at the disposal of the foreign creditors was sheer illusion.

In the course of the years of depression, however, the system of blocked accounts provided a channel through which at least part of the international indebtedness could be liquidated. Those foreign creditors who accepted payment on blocked account managed to dispose of a large part of their claim by selling their blocked currencies at fairly substantial losses. At the same time, the partial or complete default on various external bonds brought about a fall in their price which, together with the depreciation of the currencies of some creditor countries, made it desirable for the debtors to repatriate the bonds. Large amounts were re-purchased by the debtor Governments and firms, and in addition considerable amounts were repatriated by nationals of the debtor countries, thus making the debts internal instead of international. The reduction in international indebtedness through repayment under par or repatriation must have been quite considerable during the years of depression.

(3) Depreciation of Creditors' Currencies

Apart from this, the depreciation of the currencies of the creditor countries also liquidated a fair percentage of the inter-

national indebtedness. Expressed in terms of the currencies of those debtor countries which maintained their old parities, the amount of sterling and dollar bonds declined considerably. This did not, however, materially reduce the real burden of these debts, since the depreciation of sterling and dollar was accompanied by a heavy fall in commodity prices in the debtor countries on a gold basis. Thus, while it is true that the transfer of a certain amount of sterling or dollars required a smaller amount of the national currency of the debtors, it is equally true that the transfer of that smaller amount of national currency required the export of almost the same amount of commodities as before the depreciation of sterling and dollar. The reduction of debts through currency depreciation was thus more apparent than real.

The depreciation of sterling and dollar reduced the value in gold currencies of foreign balances and investments held in London and New York. The reduction was more apparent than real, however, since prices in the creditor countries declined materially after the depreciation of their currencies. Thus, from the point of view of creditor countries as a whole, all that happened was that the commodity value of foreign sterling and dollar holdings failed to increase in spite of the fall in commodity prices. From the point of view of individual creditors, however, the loss in terms of gold currencies was substantial.

It is as yet impossible to form an opinion about the definite effect of the crisis upon international indebtedness. It is conceivable that should the period of exchange restrictions and transfer moratoria continue for some years, the reduction through repayment and repatriation will make further progress.

(4) Debt-Funding Problem

When conditions begin to assume a more normal appearance, then it will be necessary to come to terms with the debtors. Debt-funding agreements will have to be negotiated on a totally different basis. Nobody expects that after the depression is over most debtors will resume the full service of their external debts, unless, in the meantime, commodity prices have risen to such a level that the burden of their debt service has become comparatively light. In the majority of cases creditors will have to accept a permanent cut in the debt service, just as they had to consent to cuts after the war in the pre-war loans of Austria, Hungary, Bulgaria, etc. Owing to the demoralising effect of the crisis, debtors will doubtless endeavour to pay as

little as possible, and if they pay anything at all, it will be because they want to borrow afresh.

Painful as this process of reduction of international commercial debts will be for individual investors, some such drastic readjustment has been rendered inevitable by the excessive increase of international debts and by the increase of their real burden to an intolerable degree through the fall in commodity prices. The liquidation of a large part of international commercial indebtedness, in addition to the elimination of political indebtedness, will go a long way to put the international financial system on a safer basis. The smaller the volume of international indebtedness, the less the world will be exposed to shocks such as we experienced in 1931 and after.

Doubtless it would have been more desirable for all parties concerned if the reduction of the international commercial indebtedness had taken place through a substantial rise in commodity prices. As it is, the fall in commodity prices increased the burden of international indebtedness to such an extent as to make it inevitable for many debtors to default, and since default is a contagious disease, many who would have been able to carry on followed the example of those who were genuinely compelled to suspend the debt service. The losses caused by the partial or complete suspension of interest and sinking fund are probably much larger than any losses that could conceivably have been caused by a rise in commodity prices. What is more, creditors stand to lose through default to a much larger extent than through the depreciation of their claims in terms of commodities. In many cases, they use the bonds as security against loans, and a depreciation of the commodity value of their claims would, at the same time, reduce the burden of their debts. In the case of default, however, the burden of their debts remains, while the commodity value of their claims is reduced. It is evidently contrary to the interest of the creditors themselves to drive deflation to such extremes as to make the burden of debts unbearable. While they may benefit to some extent by moderate deflation, when deflation assumes an advanced stage they stand to lose more than they can possibly gain.

CHAPTER XXXVII

SUMMARY OF PART III

(1) A Brief History of the Crisis

The history of the past twenty years abounds in interesting periods, but even amongst them the period of the world crisis is of outstanding interest. The Wall Street slump provides one of the most highly dramatic events of financial history, though it is probably surpassed by the Central European crisis, the sterling crisis, and the dollar crisis. Events such as the Creditanstalt affair or the Kreuger crash, which in more normal times would have been the outstanding events of the crisis, were mere episodes in the long series of crises.

Let us now recapitulate the history of the deflationary period. It began with the Wall Street slump which caused acute economic depression in the United States, partly owing to the direct losses on securities and partly as a result of the curtailment of purchases brought about by the pessimism of the consumers regarding the outlook. The depression soon spread over the greater part of the world. There was a heavy slump in commodity prices and an increase of unemployment in most countries. In several countries there were a number of secondary bank failures. Banks in most countries considered it advisable to curtail credit, thereby accentuating the depression. The weak undertone of sterling during the second half of 1930 provided an additional cause for pessimism.

Towards the beginning of 1931 there were signs of a moderate recovery. Sterling improved and there were slight improvements in trade though the movement was by no means general. Political uncertainty caused by the Franco-German disagreement over the customs union scheme between Germany and Austria soon caused a relapse. The situation became considerably aggravated by the difficulties of the Creditanstalt, which provided the starting point of a financial crisis of unprecedented dimensions. Foreign funds were being withdrawn in great haste from Central Europe, causing considerable embarrassment to the debtor countries whose gold reserves were dwindling down rapidly. Although Austria received support

from the Bank of England, and an agreement was reached between the Austrian Government and the foreign creditors of the Creditanstalt, the dramatic circumstances in which the support was granted were far from reassuring, and the attitude of France towards the Central European financial crisis accentuated panic.

(2) The Climax

During the second half of June the storm centre shifted from Austria to Germany. The Reichsbank received a substantial credit to enable it to withstand the strain caused by foreign withdrawals, but in face of the persistence of the run it proved to be inadequate. President Hoover's proposal of a twelve months' moratorium on war debts and reparations was accepted only after some delay and failed to produce the psychological effect that was expected. Industrial difficulties in Germany resulted in a run of depositors upon several banks and it was impossible to obtain the collaboration of all banks to check the menacing developments. On July 13 the German Government declared a moratorium on all bank payments. This moratorium was gradually repealed in the case of internal payments, but was perpetuated in the case of external short-term debts through the conclusion of a standstill agreement.

Towards the end of July the storm centre shifted from Germany to England. The crisis in Central Europe led to heavy withdrawals of foreign funds deposited in London, partly owing to fears of a depreciation of sterling, and partly owing to distrust in the banks, some of which had committed themselves to too great an extent in Central Europe. The Bank of England raised its rediscount rate from 2½ per cent to 4½ per cent and concluded a credit of £50 millions with France and the United States. These measures failed, however, to check the flight from the pound, which continued after the change of Government. A second credit amounting to £80 millions was equally unable to reassure foreign holders of sterling. After the Invergordon naval incident, the selling pressure became accentuated, and on September 21 the Government had to decide to suspend the gold standard.

(3) The Slump of Sterling

There was a heavy slump of sterling which inflicted heavy losses on foreign holders of sterling balances, amongst them a number of Central Banks. A number of countries followed the British example, and there was a wave of distrust of those

currencies which remained on the gold basis. Withdrawals of Central Bank deposits from New York caused a run on the dollar, which, however, subsided before long. Amidst the chaotic financial conditions during the last quarter of 1931, a number of countries sought to defend their currencies through the establishment of exchange restrictions and trade restrictions of various kinds. In November there was a flight from the yen which compelled the Japanese Government to suspend the gold standard early in December.

Towards the turn of the year there was a distinct improvement in the international situation. Sterling began to recover largely as a result of the favourable impression caused by the efforts to balance the budget. The British authorities were able to buy a sufficient amount of dollars and francs to repay the credits contracted in defence of sterling. They were able to accumulate, in addition, a substantial foreign exchange reserve. There was a flight to the pound as a result of distrust of the dollar, and from time to time also of the franc. In order to improve the facilities with which to control sterling, the British Government established the Exchange Equalisation Account in April 1932.

The flight from the dollar came to a halt towards the middle of 1932, and at the same time the conversion of the British 5 per cent War Loan resulted in some withdrawal of foreign capital from London. This, together with the seasonal pressure and the anticipation of the war debt payment in December, caused sterling to depreciate considerably during the autumn. Towards the turn of the year, however, it recovered once more. There was a renewed flight to the pound, at first owing to the budgetary difficulties of France and subsequently owing to the banking crisis in the United States.

(4) The Crisis in France and the United States

The budgetary difficulties of France were caused by the depression which began to make itself felt in France from 1931 onwards. There was also a severe banking crisis and the Treasury had to use up its remaining liquid resources in order to support some leading banks. Towards the beginning of 1932 the banking crisis in France, as in most other countries, subsided. Although the Kreuger crash dealt a severe blow to the international banking structure, its actual effect was less disastrous than might have been anticipated.

The wholesale failures of American banks and the publication of the figures of the assistance given by the Reconstruction

Finance Corporation caused a panic among American depositors. There were runs on banks all over the United States, and it became necessary to declare bank holidays in a number of States. The situation was aggravated by the fact that the outgoing President was not in a position to take drastic action. When President Roosevelt assumed office on March 3, 1933, his first act was to declare a bank holiday all over the United States and place an embargo on the export of gold. A large number of banks were not reopened pending the investigation of their situation. For a few weeks the dollar was maintained at its parity, but from April 20 onwards it was allowed to depreciate. President Roosevelt adopted a policy aiming at the depreciation of the dollar in order to bring about a rise in commodity prices. Owing to this, the attempt to bring about an agreement on stabilisation at the London Economic Conference in 1933 had no chance to succeed. After an attempt to peg sterling in relation to the gold currencies, it was allowed to follow the dollar.

(5) The End of Deflation

The depreciation of sterling after 1931, and the depreciation of both sterling and dollar after 1933, produced a deflationary effect upon countries which remained on a gold basis. There was a heavy decline in their commodity prices, and this aggravated their economic depression. This influence more than counteracted the favourable effect of an agreement on reparations at Lausanne and of the virtual settlement of war debts through default. While conditions in the United States and in the countries of the Sterling Bloc improved materially, those in countries of the Gold Bloc went from bad to worse. France underwent a particularly severe financial and political crisis towards the end of 1933 and at the beginning of 1934. Drastic measures taken subsequently in order to balance the budget restored confidence in the franc, but caused an aggravation of the economic depression. In other countries on a gold basis, deflation produced similar effects. Towards the end of 1934 the new French Government decided to refrain from deflating any further, and the rest of the Gold Bloc followed its lead.

With the decision of the countries of the Gold Bloc not to deflate any further, the period of deflation, which began with the Wall Street slump, may be said to have come to an end. It is possible that in some countries prices may fall further, but on the whole it is safe to assume that deflation has, in most

countries, reached the limit beyond which it would automatically set into motion factors tending to reverse the process. Thus, it is now possible to survey the development of that period from the perspective of history, and to form an idea about the causes and effects of the deflationary movement.

(6) Cause of Deflation

Let us begin with the direct causes and proceed towards the fundamental ones. The most superficial of all causes was the speculative boom that preceded the crisis. Evidently, in 1929, securities were grossly over-valued, and their exaggerated rise was bound to be followed by a fall. It was inevitable that the fluctuations on the Stock Exchanges should follow the natural laws of the pendulum, and that an exaggerated rise should provoke an equally exaggerated fall. Unquestionably, five years of depression have liquidated the inflated value of securities, as far as the ordinary shares or common stocks are concerned. In this respect, the abnormal situation existing in 1929 has received ample correction. During 1933 and 1934 the exaggerated fall that followed the exaggerated rise also readjusted itself to a large extent, so that it may be said that generally speaking there is nothing glaringly abnormal in the position of security prices.

A second cause of the deflationary crisis was the fall in commodity prices. It is possible to argue that the fall in prices was the effect and not the cause of the crisis, but in reality we are confronted with a vicious circle in which falls of price and depression chase each other incessantly. The two phenomena occurred simultaneously and it is impossible to say which was the cause and which the effect at any given moment. If we regard the period of depression as a whole, it was both the cause and the effect of the fall in prices. While the deflation of security prices was a process towards readjustment, the deflation of commodity prices further accentuated the disequilibrium from which the world was suffering before 1929. It is impossible to maintain that commodities in 1929 were overvalued. While they were high compared with their level in 1913, there was no reason whatsoever to assume that the pre-war level was necessarily the normal to which prices should always tend to return until the impact of our globe with some other planet puts an end to the problem. It is true that from the point of view of the volume of monetary gold, commodity prices were too high, but from the point of view of the volume of fictitious wealth, they were evidently too low.

(6) Disequilibrium Increased

Doubtless the fall in commodity prices went a long way towards removing the disequilibrium caused by the shortage and maldistribution of gold. At the same time, however, it further increased the disequilibrium between fictitious wealth and real wealth. It is true that fictitious wealth has become reduced to a large extent through the slump in security prices and through the series of defaults by debtors. The disappearance of reparations and war debts also reduced fictitious wealth by a considerable item. The defaults on foreign Government and other public corporation debts, painful as they were from the point of view of bondholders, constituted another important item written off the balance sheet of fictitious wealth. Bank failures and the insolvency of the innumerable private debtors was another painful way in which fictitious wealth was reduced. Unquestionably, its reduction took place in the wrong way. The same percentage of reduction might have been achieved with much less disturbance and probably with much less iniquity through the depreciation of the commodity value of currencies. Instead, there was an appreciation which probably more than cancelled out the reduction in the volume of real wealth through defaults.

At the beginning of the depression, credit restrictions had undoubtedly contributed towards the slump. Subsequently this factor gradually ceased to play any part, for the simple reason that the demand for credit declined owing to depression and to the fall of prices to a larger extent than its supply. While the factor of credit restrictions may have played an important part in the slump in 1929 and 1930, subsequently the process of deflation went on through the reciprocal effect of depression and falls of price upon each other. From 1931 onwards the depreciation of sterling assumed predominant importance among the factors leading to further deflation in the countries on a gold basis. From 1933 onwards the depreciation of the dollar began to play a similar rôle. In spite of this neither Great Britain nor the United States are to blame for the sufferings inflicted upon the gold countries by deflation. It was the latter's own stubborn determination to maintain their own parities, in spite of the heavy slump of commodity prices, that was responsible for their troubles.

The depreciation of sterling, the dollar and a number of other currencies was a movement in the right direction. It tended to remedy the shortage of gold by making the same

amount of gold do more work and become the potential basis of a larger volume of credit. At the same time, it also tended to reduce the disequilibrium between fictitious wealth and real wealth. To the extent to which inland prices in the countries with depreciated currencies have followed the depreciation of their exchanges, fictitious wealth in the countries concerned has been reduced. To the extent to which inland prices have not followed the depreciation of exchanges, the disequilibrium caused by gold shortage has been reduced. Both factors were in the right direction. The result was achieved with the least possible inconvenience to the countries concerned.

PART IV
REFLATION

CHAPTER XXXVIII

WHAT IS REFLATION?

(1) Movement not yet World-Wide

We propose to examine in this part of the book the fourth phase of financial history after 1914, that of reflation. The task is more difficult than the examination of the first three phases, those of inflation, stabilisation and deflation, since the period of reflation has barely begun. The first two phases terminated years ago, so that it is possible to consider them in the perspective of history. The third phase, that of deflation, may possibly be said to have come to an end, even though its termination is quite recent and may be open to doubt. On the other hand, the period of reflation has not yet assumed a general world-wide character. In some countries it has been going on for some time. In Great Britain and a number of other countries it began in 1931 with the suspension of the gold standard. In the United States it began in 1933 with the suspension of the gold standard and with the application of President Roosevelt's reflationary policy. In Germany it began with the advent of the National Socialist regime with its extensive public works and rearmament programme, which turned the tide of commodity prices. In Japan it began with the suspension of the gold standard and with the advent of big budgetary deficits.

In the countries of the Gold Bloc, however, reflation has not actually begun yet. In Italy, deflation came to an end during 1934, and the French Government declared it to be over at the end of that year. The French Government went indeed a step further by announcing a new policy which is calculated to bring about a certain degree of reflation. The chances are that the other countries of the gold group will follow its lead. At the time of writing, however, there is as yet no sign of actual reflation in any of the countries of the Gold Bloc.

(2) Deliberate *v.* Spontaneous Reflation

The term reflation is of quite recent origin. While inflation, stabilisation and deflation have become part of the vocabulary

of the man in the street, reflation is still a term which is comparatively unknown among the general public outside the United States. It was President Roosevelt's recovery programme that gave rise to this new term, the meaning of which requires definition. Reflation is an inflationary movement tending to reverse a deflationary movement that has preceded it. It is sometimes described as a deliberate inflationary movement, but this is not necessarily so. Just as both inflation and deflation can be either deliberate or spontaneous, so reflation can either be the result of a deliberate monetary policy or of circumstances over which the authorities have no control.

A typical example of deliberate reflation is provided by President Roosevelt's monetary policy. In this case action has been taken in the form of a deliberate suspension of the gold standard; the adoption of extensive programmes of subsidies and other public expenditure; the introduction of a system tending to facilitate the increase of wages; the deliberate depreciation of the dollar; the revaluation of the gold reserve; and the adoption of a programme of remonetising silver at a higher price. All these actions pursued the end of reversing the deflationary trend that began in 1929.

A typical instance of spontaneous reflation was provided by Great Britain. The pound was forced off gold as a result of the working of irresistible forces, and this brought about a certain degree of reflation through the depreciation of sterling. Another typical example is being provided by the gold countries where deflation has been carried to such an extreme that it automatically sets into motion factors tending to reverse the process.

Every inflationary movement that follows deflation cannot necessarily be termed reflation. If an inflationary movement is interrupted by a reaction, and after a while it resumes its course once more, this new phase of inflation can hardly be regarded as reflation. It is simply the continuation of the original movement. This is what actually happened in the inflationary group of countries after the post-war slump of 1920–1. In France, Germany and the rest of the former continental belligerent countries, post-war inflation was temporarily interrupted by the slump, but it resumed its course after a provisional setback in prices. This second phase of inflation could hardly be termed reflation, even though it followed a phase of deflation. The difference between this phenomenon and that of the inflation that we witnessed in the

United States in 1933–4 is that in the former instance the same inflationary factors remained at work throughout the post-war period, and their effect was only temporarily offset by passing deflationary forces, while in the second instance, inflation was due to entirely new factors which did not exist at all during the period of deflation. In the case of France in 1921, the influences that resulted in the resumption of inflation were not brought about by the slump, nor were they the result of a deliberate change in monetary policy. All that happened was that the influences which for a short while counteracted the inflationary factors ceased to operate. In the case of the United States and the other countries where reflation took place from 1931 onwards, the situation was entirely new, and was created as a result of the slump.

(3) Deflation Reversed Automatically

Let us now examine the circumstances in which reflation takes place spontaneously without any deliberate reflationary policy on the part of the authorities. In normal conditions, spontaneous reflation is an integral part of the trade cycle. It automatically follows the trade depression. When the cyclic crisis attains a certain degree, influences arise tending to bring about a revival of business activity and an expansion of credit, which in the course of time may assume an inflationary character. The circumstances in which reflation took place automatically in a number of countries as a result of the deflationary crisis of 1929 to 1934 were somewhat different. This time it was not a revival of trade that brought about a reflationary expansion of credit. It was, on the contrary, various reflationary influences that brought about some revival of trade.

The circumstances in which automatic reflation originated and worked during the last few years varied according to the countries. The degree of deflation that was required in each country to set in motion reflationary forces varied widely according to the resisting capacity of the countries concerned. In Germany, reflationary forces began to operate during the summer of 1931, when the necessity of granting extensive official support to banks, savings banks, etc., resulted in an expansion of credit. The German authorities succeeded, however, in preventing reflation from taking its course by applying stringent deflationary measures. The resisting capacity of Great Britain to reflationary influences was exceptionally low in 1931, owing to the inelasticity of wages, the budgetary deficit,

the reluctance of the Labour Government to impose protective duties and the exceptionally weak technical position of the monetary authorities. It was owing to all these circumstances that Great Britain was one of the first countries to yield to the influence of automatic reflationary forces by suspending the gold standard. At the same time, Great Britain put up a resistance to reflation by raising the bank rate and by taking Draconian measures to balance the budget.

In the United States, the main factor which provoked and stimulated reflationary influences was the banking crisis. Had the new Administration not chosen to adopt a policy of deliberate reflation, the accentuation of the crisis through the wholesale failure of the banks would in itself have provoked a reflationary effect.

(4) Reflationary Influences and the Gold Bloc

In France and in other countries of the Gold Bloc reflationary factors have been at work ever since 1931. The authorities have so far succeeded, however, in resisting their influence. The necessity of supporting banks in difficulties tended to provoke reflation in Italy and in Belgium ; it did not have a similar effect in France for the simple reason that the Treasury had, at the time of the banking crisis, sufficient cash resources to support the banks without any creation of new credit. The economic depression induced Italy, and to a less degree France, to adopt a certain measure of deliberate reflation in the form of public works financed by loans. In the case of Italy, this policy, together with other reflationary influences, actually succeeded in checking deflation during 1934.

In France, deflation continued throughout 1934, notwithstanding the reflationary effect of public works. A much more important reflationary influence was the budgetary deficit. To a large extent it was covered with the aid of deflationary measures through increasing revenue and cutting down expenditure. On the other hand, a large part of the deficit in each gold country had to be covered by applying reflationary means of borrowing. Ever since 1932, the most important reflationary factor in France has been the difficult cash position of the Treasury. From time to time this has threatened to lead to inflation, but up to the time of writing inflation has been avoided. At the beginning of 1935, however, the French Government adopted a policy which, if it were successful, would lead to reflation.

(5) Various Forms of Deliberate Reflation

A deliberate reflationary monetary policy may assume a variety of forms. In this respect it does not differ from ordinary inflationary monetary policy. The most innocuous, but at the same time ineffective way is to attempt to reflate through a policy of cheap money. This is the policy adopted by the British Government from 1932 onwards, and this is the policy the French Government appears to have the intention of adopting at the beginning of 1935. Another method of reflation is a policy of public works. This policy need not necessarily have for its object the bringing about of reflation. The German, Italian and French Governments had undertaken public works, not in order to reflate but in order to mitigate the adverse effects of the trade depression upon employment. In the case of Germany, the policy of public works produced a strongly reflationary effect, but in France and Italy it did not check deflation. From the point of view of its effect, it matters little whether the Governments want deliberately to increase purchasing power in order to reflate. They may merely want to subsidise a certain class of producers or consumers, and the result is an increase in spending capacity which produces reflationary effects. This method of reflation was extensively applied in the United States, and to a less extent in every country where the Government supported the unemployed by means of subsidies, or where it had to assist particular firms or particular trades in difficulties.

Yet another method of deliberate reflation is to abstain from resisting a depreciation of the currency. If a Government suspends the gold standard because it is not in a position to maintain its currency at par any longer the reflation thus provoked is spontaneous. If, however, the Government suspends the gold standard in spite of the possibility of maintaining it for some time, at any rate, the reflation in that case is deliberate. The crudest form of deliberate reflation is to unbalance the budget and cover the deficit with the aid of the Printing Press. Up to now no country has resorted to this method.

(6) Moral Aspects of Reflation

The moral aspects of reflation also deserve close attention. When reflation is spontaneous, the question of the right or the wrong of the official attitude should not arise at all. In practice, however, it does arise on every occasion. For no

matter how obvious it is that the working of reflationary influences is automatic, there are always critics who attack the authorities for having failed to counteract them. In the eyes of orthodox economists, it is the sacred duty of Governments to prevent reflation at all costs. No sacrifice is too heavy for them if it tends to counteract reflationary influences. If they were in a position to choose between ruining production and allowing automatic reflationary factors to take their course, they would choose the first alternative without hesitation, and they consider it an unforgivable sin if responsible Governments are not prepared to choose the first alternative. What they do not realise is that there is, in reality, no choice, since after a certain degree of deflation reflationary influences become irresistible.

Admittedly, the limit to which deflation can go is elastic. But it is impossible to get away from the fact that reflationary forces prevent the pursuance of deflation indefinitely. The question that may be subject to argument is whether it is the duty of Governments to fight reflation to the utmost and go down fighting, or whether they are justified in allowing reflation to take its course when their defeat is obviously a mere question of time. Anyone but fanatical deflationists would endorse the second alternative.

The controversial character of the moral aspects of reflation is much more pronounced in the case of deliberate reflation. Here again, however, the case of dogmatic deflationists is a weak one. They may be on safe ground in putting forward moral arguments against inflation as such, although their arguments are weakened by the fact that the policy they advocate is as immoral as inflation itself. When it comes to opposing reflation on moral grounds, however, the untenability of their arguments is evident. They are right in maintaining that inflation consists of robbing Peter to pay Paul. They wisely omit to say, however, that deflation consists of robbing Paul to pay Peter. There is nothing much to choose between the two courses from the moral point of view. When it comes to reflation, however, the state of affairs is totally different. Paul the debtor and producer has already been robbed by means of deflation for the benefit of Peter the creditor and consumer. All that reflation does is to restore to Paul at the expense of Peter what was unjustly taken away from him. Surely there is nothing immoral in this adjustment. Or is it a matter of supreme justice that Peter should retain his unearned gains obtained through deflation? It may be argued

that between 1914 and 1920—or 1926 in some countries—Peter had actually been robbed by inflation for the benefit of Paul, and that the deflation that has taken place since has merely restored to Peter what originally belonged to him. In reality, by far the larger part of indebtedness was contracted when commodity prices were well above their present level, so that the number of Peters who would suffer losses if prices were to be restored to their level of 1926 would be much smaller than the number of Pauls who would be victimised if such a rise in commodities were prevented.

CHAPTER XXXIX

REFLATION IN GREAT BRITAIN

(1) Reflation Tempered by Deflation

The suspension of the gold standard in Great Britain constituted the first reflationary change of importance during the crisis. The reflationary influences set into motion by the depreciation of sterling during the last quarter of 1931 were considerable, and yet their actual reflationary effect was negligible. After a temporary jump, commodity prices settled down in the vicinity of their pre-war level, and remained there, smaller fluctuations apart, throughout the period under review. This was contrary to general anticipations. It was expected that the depreciation of sterling would result in a material rise in prices, and that its influence would check the world-wide trend of deflation. Instead, prices remained relatively stable in Great Britain, and the depreciation of sterling was accompanied by the accentuation of world-wide deflation. The main reason for this was that the reflationary act of suspending the gold standard was accompanied both in Great Britain and in the countries on a gold basis by a series of strongly deflationary measures. The bank rate was raised in Great Britain to panic level; purchasing power was severely curtailed by an orgy of cuts in wages and salaries, both by the Government and by private employers; the budget was balanced through severe taxation and economies; and there was an all-round downward drive of prices. Such traces of reflation as became evident immediately after the suspension of the gold standard had disappeared by the turn of the year. The countries which remained on a gold basis also took strong deflationary measures following upon the suspension of the gold standard in Great Britain. At various times they made efforts to reduce Government expenditure; their producers and merchants did their utmost to cut costs so as to compete with their British rivals in spite of the latter's advantage obtained from the depreciation of sterling; the monetary authorities of the gold countries also pursued a deflationary monetary policy. In the circumstances, the rise in commodity prices in Great Britain naturally failed to

provoke a sympathetic movement in countries which retained their old parities.

From the beginning of 1932 there was a deflationary tendency in Great Britain as a result of the strong appreciation of sterling. This tendency was partly neutralised by the intervention of the authorities preventing, or at any rate delaying the rise in sterling. Their intervention did not in any way constitute an act of reflation. All they tried to do was to prevent deflation. At the same time, the gradual reduction of the bank rate caused money to be easier. From February 1932 onwards the Government began to pursue a policy of cheap money. The bank rate was gradually reduced from 6 per cent to 2 per cent during the first half of 1932. This, together with the investment by the public of idle funds in Government securities, brought about a rise in the gilt-edged market, which enabled the Treasury to launch out on its bold conversion scheme of the 5 per cent War Loan. The success of this scheme was followed by a series of smaller conversion operations by the Government, various Dominion and Colonial Governments and municipalities. Cheap money worked its way, in accordance with the classical rules, from the market of short-term credits through Government and other public corporation loans into industrial securities.

(2) Causes of Cheap Money

From the point of view we are concerned with in this chapter, it is interesting to know how far cheap money was the result of deliberate monetary policy, and how far it produced actual reflationary effect. In a statement made in the House of Commons in December 1934, Mr. Neville Chamberlain emphatically claimed credit for the all-round decline of interest rates, which he attributed entirely to the Government's policy. This view is open to criticism. Doubtless the orthodox budgetary policy pursued by the Government went a long way towards preparing the ground for a decline of interest rates. The bank-rate policy was equally helpful, though in this respect it must be admitted that, to a large extent, the bank rate merely followed the tendency of open market rates. It would be idle to deny that the boldness with which the Treasury tackled the 5 per cent War Loan removed the chief obstacle to a substantial decline in long-term interest rates. The embargo on foreign loans, and more particularly the embargo on domestic issues, which was maintained long after the success of the big conversion operation was assured, was also helpful in creating cheaper money.

Those, however, who are tempted to conclude that Mr. Chamberlain was right in claiming that cheap money was entirely the result of the official policy should be reminded that interest rates in the United States have declined to almost as low a level as in Great Britain, although the Government's policy was totally different from the one adopted by the British Government. There the budget was deliberately unbalanced, and in spite of the huge deficit the yield on long-term Government securities declined to 3·2 per cent, which is only slightly higher than the yield on British Government securities. As for bank bill and Treasury bill rates, for a long time past they have been much lower in New York than in London.

There can be no doubt that both in Great Britain and in the United States there was a factor which played a larger part in bringing about cheap money than anything the Governments have done or have left undone. That factor was the prolonged trade depression. Demand for commercial credits continued to remain slack, and new investment facilities in both countries remained well under the amount of new savings. This accounts for the greater part of the decline in interest rates. Thus it may be said that this decline was largely spontaneous, the inevitable consequence of the economic depression.

(3) Limited Direct Effect of Cheap Money

The next question is whether the decline of money rates produced a reflationary effect. It certainly did not lead to any noteworthy rise in commodity prices. On the other hand, it created additional purchasing power in the form of a rise in security prices. This does not mean that holders of Government loans or other securities necessarily hastened to spend their capital appreciation. At the same time, it is beyond doubt that they were more inclined to spend up to the limit of their incomes as a result of the additions to their capital. It is true, however, that the conversion operations resulted in a decline in incomes on a considerable amount of capital.

The spokesmen of the rentier classes argue sometimes that conversion is really bad for trade, since it reduces purchasing power. In reality, the purchasing power thus deducted from the incomes of rentiers does not evaporate. It is only transferred to other classes of consumers. If it leads to a reduction of taxation it will increase the purchasing power of taxpayers; if the Chancellor of the Exchequer spends it on shipping subsidies, it will increase the purchasing power of those engaged in shipping, etc. The chances are that the result will be a better

distribution of purchasing power from the point of view of its active employment for purchases, since a large portion of fixed interest-bearing securities is owned by big holders whose spendings are not influenced by the reduction of their incomes, or at any rate, not to a corresponding degree. It is true that the conversion of overseas loans reduced the purchasing power of British investors without at the same time raising that of any other section of the British community, and thus the net result was the reduction of the total purchasing power within Great Britain. The amount involved in the conversion of overseas loans was, however, insignificant compared with the amount involved in the conversion of British issues. This factor was not important enough to modify the conclusions about the effect of conversion upon purchasing power. It may be said, therefore, that any redistribution of incomes through conversion tends to increase rather than reduce the demand for goods and services.

Notwithstanding this consideration, the extent to which cheap money produces direct reflationary effect is negligible. Its influence is, however, of great importance as it prepares the ground for other reflationary factors. While cheap money in itself does not create reflation, dear money goes a long way towards preventing reflation. In a negative sense, the consequences of cheap money should not be under-rated.

(4) President Roosevelt's Influence

Whatever reflation there was in Great Britain between 1931 and 1934, it was not caused to any large extent, either by the depreciation of sterling or by the policy of cheap money. The main factor in the reflationary recovery that occurred during 1933 and 1934 was the rise in commodity prices in the United States, brought about by President Roosevelt's reflationary policy. Since sterling followed the dollar to a large extent, the rise in commodity prices in the United States was accompanied by a slight rise in British commodity prices. It was this rising trend which stimulated business.

It is sometimes argued that the recovery which occurred in 1934 in Great Britain was a natural sequel to the prolonged depression. For a number of years, consumers had reduced their purchases to a bare minimum and a stage had been reached at which it had become inevitable for them to renew their wardrobes, repair their houses, etc. There is doubtless a great deal of truth in this, but it may well be asked how it was that only the consumers of the countries with depreciated currencies

decided to resume their purchases, while those of the gold countries continued to refrain from buying. The explanation lies in the fact that while in the former group of countries commodity prices were rising, in the latter group of countries they continued to fall. It was the realisation that commodity prices were not likely to fall any lower and that if anything they were more likely to rise that induced British consumers to increase their purchases during 1934. The same consideration was also largely responsible for the increased building activity.

(5) Effect of Higher U.S. Prices

The reflationary effect in Great Britain of the rise in American commodity prices was not by any means purely psychological. It resulted in an actual increase in the yield of British overseas investments through a sympathetic rise in commodity prices in most raw-material-producing countries. The shareholders of British enterprise in the Dominions and Colonies, Latin America and the East obtained higher dividends. Interest on debentures was resumed. There was thus an actual increase in purchasing power. What is much more important, the rise in produce prices increased the purchasing power of the British agricultural population. The importance of this factor is often overlooked, although agriculture is still by far the most important industry in Great Britain, and the purchasing power of those engaged in it is by no means a *quantité negligeable*.

Thus, the trade recovery in Great Britain was largely due to the reflationary monetary policy of President Roosevelt. The British Government itself did very little actively to assist in the recovery. It is true that on repeated occasions, spokesmen of the British Government declared themselves in favour of a rise in commodity prices, but the Government took little or no actual action to obtain this desired end. This attitude may be compared with that of one of Oscar Wilde's heroes who said that he would do anything to keep young, except get up early, take exercises, or lead a moderate life. The British Government too would do anything to raise prices, except adopt any of the effective methods of reflation. Notwithstanding the pressure of public opinion, it refused to undertake any ambitious public works schemes, such as slum clearance on a really large scale or road building to cope with the increased traffic. Suggestions that the Government should issue a large housing loan were rejected. The budget remained balanced and the Government was not prepared to depart from financial orthodoxy in this respect. Nor was it prepared deliberately to depreciate sterling.

Indeed, during the greater part of 1934 a large part of the gold resources of the Exchange Equalisation Account were used up in order to prevent a natural depreciation of sterling caused partly by the adverse trade balance and partly by the outflow of American and continental balances which took refuge in London in 1933 and early in 1934. Although it is an open secret that the existing sterling-dollar rate between 4·86 and 5·00 is considered much too high in official quarters, nothing has been done to adjust the rate to a figure which is more in accordance with requirements. Indeed, the authorities have done everything to prevent such adjustment, even when it was trying to come about spontaneously. Although, according to Mr. Neville Chamberlain's statement in December 1934, prices in the United States are considered too low compared with British prices, no action is taken to remedy this state of affairs by a downward adjustment of sterling. It is apparently hoped that the adjustment will take place through the rise in commodity prices in the United States.

The only active contribution of the British Government to reflation consisted of the restoration of part of the cuts in unemployment relief and in wages and salaries of Government employees. The direct effect of this action is moderate, but it has produced an indirect effect in inducing a number of employers to follow the example. Taking all into consideration, it may be said that in Great Britain the extent of reflation brought about by deliberate policy has been negligible. Whatever reflation took place was largely spontaneous and was the result of reflationary policy in the United States.

CHAPTER XL

REFLATION IN THE UNITED STATES

(1) Deliberate Action

The United States was the only country in which reflation was put into practice on a really substantial scale, in execution of a deliberate monetary policy. We shall see in a later chapter that the two other countries which reflated to a considerable extent, Germany and Japan, did not do so in pursuance of a reflationary monetary policy. It was not the object of the German or the Japanese Governments to raise prices. In Germany the Government's aim was to reduce unemployment and to rearm the nation, and the rise in commodity prices and expansion of credit that accompanied the process was considered a necessary evil which a country must put up with, and which the authorities sought to reduce to a minimum. In Japan the depreciation of the yen was not engineered deliberately in order to produce reflation. It took place as an inevitable consequence of the abnormal expenditure on military enterprises in Manchukuo and China. It was only in the United States that expenditure was increased and the currency was deliberately depreciated in order to bring about a rise in commodity prices.

Admittedly, the official support that had to be granted to a large number of banks and other undertakings constituted a reflationary factor which was independent of the Government's monetary policy. Had the United States remained on a gold basis this factor would not, however, in itself have resulted in an actual rise in prices. Government support to an insolvent bank does not create any additional purchasing power. All that it does is to prevent a wholesale contraction in purchasing power through a bank failure.

The way in which Government support to insolvent banks or alternatively wholesale suspension of banks would have produced a reflationary effect would have been through causing a flight from the dollar which in the long run would have ended in the suspension of the gold standard. So long as the United States resisted the pressure on the dollar thus caused, neither support to the banks nor wholesale insolvencies would have

produced an actual rise in commodity prices. Given the fact, however, that the support given to banks coincided with various deliberate reflationary measures, it had its share in contributing towards reflation.

Another spontaneous reflationary factor was the depreciation of the dollar caused by the flight of capital that followed the suspension of the gold standard. As, however, the gold standard was suspended by deliberate action in pursuance of the monetary policy of the new Administration, this spontaneous depreciation of the dollar may be considered to have been the consequence of a deliberate monetary move.

(2) Reflation Morally Justified

If ever there was a country in which a reflationary monetary policy had full moral justification it was the United States. As a result of the slump in commodity prices, the burden of private indebtedness was becoming increasingly unbearable as the process of deflation went on. Since the slump was particularly severe in produce prices, the agricultural population was affected to a very large extent.

It is sometimes suggested that an alternative solution to reflation would have been Government support to " deserving cases ". Those who are acquainted with the extent to which politics influence administrative activity in the United States must be aware that the adoption of this solution would have led to most unfair discrimination. And in all probability it would not have been those who had got into difficulties through no fault of their own as a result of deflation who received the support, but those who understood the way of pulling political and other strings. The only way to avoid political discrimination was to help farmers and other debtors in general by raising commodity prices.

The first step to that end was the suspension of the gold standard. So long as the dollar was based on gold, it was utterly futile to expect any material and lasting rise in commodity prices. This is a point the importance of which cannot be sufficiently emphasised. If on the basis of the old parities it had been possible to raise commodity prices substantially in the United States and elsewhere, the rise would have been purely temporary. It would inevitably have been followed by a relapse for the simple reason that on the basis of the old parities the volume of monetary gold was not adequate, taking the world as a whole, to support a higher price level. Given the quantity of gold available for monetary purposes, the only way

in which a rise in commodity prices can be consolidated, once it is brought about, is with the aid of the devaluation of the principal currencies. The suspension of the gold standard in Great Britain and the United States opened the way for that solution.

The next important reflationary move was the adoption of a policy of liberal public expenditure, mainly in the form of supports and subsidies. The policy of expenditure was by no means indiscriminate. President Roosevelt succeeded in resisting the pressure for the payment of soldiers' bonuses and other extravagant demands upon the resources of the Treasury. Public works were undertaken on an extensive scale. Admittedly, much of the work undertaken was useless; this was indeed inevitable, since there was no time for the elaboration of well-planned works. But money was not deliberately wasted merely in order to create purchasing power.

(3) Reflation and the "New Deal"

The following step was the effort to raise purchasing power by means of paying higher wages and salaries. The activities of the National Recovery Administration were concentrated on this aim. The idea was that trade recovery without the corresponding increase in wages would lead to an unequal distribution of the additional purchasing power, and this would handicap the progress of recovery. This consideration is systematically ignored by reactionary economists. When they talk about the inelasticity of wages as one of the principal obstacles to normal economic adjustments, they always mean the unwillingness of workmen to submit to cuts as and when commodity prices fall. They do not even consider the other side of the picture, which is that employers are as a rule also slow in consenting to rises in wages corresponding to the increase of their profits either through higher commodity prices or through an increase of production. Orthodox economists shed bitter tears about the passing of the "good old days" when trade-unionism and doles did not hamper the natural working of normal economic factors in the form of wage reductions during periods of depression. They do not, however, bother about the rigidity of the economic system in the opposite sense. If wages lag behind profits and prices during a period of prosperity, they consider it normal and natural. It is only if wages lag behind profits and prices during a period of slump that there is an outcry in their camp. And yet the inadequate degree to which wages adjust themselves to profits in an upward direction is largely responsible for the

cyclic crises and was certainly one of the factors responsible for the slump of 1929. While during the period that preceded the slump there was no rise in commodity prices, a rise in wages would have been justified none the less on the ground of increasing profits due to higher output and lower cost of production. Since before 1929 wages failed to keep pace with the rise in production, and remained hopelessly behind the rise in profits, the result was a maldistribution of purchasing power which played an important part in provoking the crisis.

It is to the credit of President Roosevelt's New Deal that he has done justice to this hitherto neglected consideration. Until he declared the raising of wages to be part of his reflationary policy, it was regarded by all but the Socialists as being contrary to the interest of trade. Indeed, it was believed that trade can only be prosperous because wages lag behind production or prices. It is the merit of President Roosevelt that he has drawn attention to the fact that higher wages are in accordance with the interest of employers themselves.

Unfortunately, the way his theory worked out in practice in the United States was not altogether satisfactory. Encouraged by the official policy of raising wages, the various workmen's unions put forward excessive demands, and under their pressure the agreements reached were not always in accordance with requirements. To a large extent, the cart was put before the horse; wages were raised to a degree which was not justified by the actual rise in commodity prices and the state of trade. Consequently, unduly high wages tended to discourage trade revival. It is inevitable that the right solution should be arrived at through trial and error, and notwithstanding the erroneous application of the principle of higher wages, it constituted an important step towards reflation.

(4) Deliberate Depreciation of the Dollar

Above all, reflation was aimed at through a policy of deliberate depreciation of the dollar. Until the autumn of 1933, the depreciation was spontaneous, largely as a result of the anticipation of inflationary measures. From October 1933 onwards a policy of deliberate depreciation of the dollar was adopted. By means of raising the official buying price of gold, the United States authorities brought about a depreciation of the dollar. The process was completed in February 1934. On January 31 the official buying price of gold was definitely fixed at 35 dollars per ounce, although the administration reserved the right to change it should it be necessary. Congress authorised the

President to stabilise the dollar between 50 and 60 cents, and the gold price of 35 dollars corresponded to 59·06 cents. In the course of February 1934, the exchanges gradually adjusted themselves to this new provisional parity of the dollar.

It is difficult to form an opinion as to what extent the various reflationary measures contributed to the reflation that has taken place in the United States. In the author's opinion, the devaluation of the dollar was the main factor. The extent to which public works and other extraordinary expenditure created actual additional purchasing power was in itself inadequate. But for the devaluation they would not have been able to produce a rise in prices comparable with the rise that has actually taken place.

(5) The "Fear of Inflation" Myth

How is it that after nearly two years of effort the extent to which prices have risen and to which unemployment has declined in the United States is still relatively small? Critics of President Roosevelt's policy would answer that it was because fears of inflation have paralysed business activity. They maintain that the National Recovery Administration and the official monetary policy inspire business men with distrust and that since it is business men who do business, their lack of confidence is responsible for the slowness with which trade responds to reflationary measures. This explanation appears to be contrary to human nature. It is absurd to suggest that business men are afraid of the rise in prices that would be brought about by inflation. Whether they are manufacturers or merchants, they can only benefit by an upward movement, so that the possibility of inflationary measures should encourage production and the purchase of commodities instead of discouraging it as is suggested by critics of the Administration. Apart from this, although much depends on business men, the main factor in trade recovery is the capacity and willingness of consumers to purchase commodities. If they are both able and willing to do so, manufacturers and merchants will certainly supply the goods for which there is demand, irrespective of their private opinions and sentiments about the Government's policy. Nor can the attitude of consumers be unfavourably affected by inflationary prospects. If they think they have reason to suppose that the result of reflation will be higher prices, they will increase their purchases and will thus stimulate production.

The real reason why the actual effect of reflationary efforts

was comparatively small lies exactly in the opposite direction to the one indicated by orthodox critics of the Administration. The critics of the Roosevelt régime are right in regarding uncertainty of the prospects of inflation as a handicap to trade recovery, though this factor produces its effect in a totally different sense from that assumed by the critics of reflation. Manufacturers are reluctant to produce and merchants are reluctant to purchase stocks not because they are afraid of reflation, but because they are afraid that there might be no reflation. Consumers are in no particular hurry to buy goods, not because they think there might be reflation, but because they hope that there will be no reflation.

(6) President Roosevelt's Inconsistency

It is the uncertainty as to whether President Roosevelt will succeed in reflating that handicaps business recovery. This uncertainty is largely the result of the inconsistency of his monetary policy, and the half-heartedness with which it is being applied. The degree to which additional purchasing power has been created is not nearly sufficient to bring about an adequate rise in prices, nor is the degree of the devaluation of the dollar nearly sufficient. From the very outset President Roosevelt's policy was characterised by hesitation between the desire to reflate and the desire to maintain Government finance on a relatively sound basis by covering all deficit through normal methods of borrowing. The Administration wanted to have the best of both worlds, and hoped that the mere promise or threat (whichever is the case) of reflation would be sufficient to cause the desired rise in commodity prices. As the anticipation of effective reflationary measures did not materialise, producers, merchants and consumers are now in complete uncertainty as to whether there will after all be any substantial degree of reflation.

The provisional stabilisation of the dollar in January 1934 failed to produce the effect that was expected of it by the orthodox school. Indeed trade in the United States was inclined to stagnate and even decline until late in the autumn of 1934, when the result of Congress election, returning a majority in favour of reflation, provided fresh stimulus to a rise in commodity prices.

While the United States Administration was incomparably more courageous in this policy of reflation than the British Government, it was not nearly bold enough to attain its end. To a very large extent, its reflationary expenditure

merely served the purpose of counteracting deflationary forces, and failed to produce any actual rise in prices and employment. In order to produce the desired result President Roosevelt must make up his mind to a further substantial devaluation of the dollar.

CHAPTER XLI

REFLATION IN GERMANY

(1) Reflation with Stable Currency

We have seen that by 1934 the world was divided into two groups of countries, those which succeeded in reversing deflationary depression through the depreciation of their currencies, and those which maintained their currencies at par at the cost of further depression. There was one country, however, which belonged to neither group, since it effectively reversed deflationary depression without depreciating its exchange. Indeed, Germany succeeded in the apparently impossible task of eating her cake and keeping it. The reichsmark remained at par with the gold currencies ; in fact, on some occasions it went to a sufficient premium to provoke an influx of gold from Holland. Notwithstanding this, unemployment declined to a very large extent and commodity prices rose considerably during 1933 and 1934.

How far was this extraordinary result due to a deliberate reflationary policy ? It is true that the Treasury of the Reich issued unemployment relief bills for the financing of public works, but a large part of these public works were already initiated before 1933, and failed to produce any reflationary effect until after the advent of the present régime. It is true that, in addition to the reichsmark which remained stable, there were various types of special currencies invented, such as registered mark, credit mark, security mark, scrips, etc., which depreciated to a large extent.

(2) A Fictitious Stability

It is often suggested that the stability of the reichsmark is purely nominal as these various types of special marks are at a heavy discount. While the moral aspects of the German claim of having succeeded in maintaining the stability of the reichsmark are open to criticism there can be no doubt that for internal purposes the reichsmark remained the only currency. The special marks are only used for international payments and their proportion to the total volume of international payments

is relatively small. To some extent the high price of goods imported with the aid of these special marks may have contributed to the rise in commodity prices, but the importance of this factor should not be over-estimated. Doubtless it was this factor, and more particularly the amounts spent on public works and re-armament, which gave reflation its first stimulus. Under the National Socialist régime reflationary expenditure was increased and the various special marks further depreciated. This may have contributed to a material degree towards reflation during 1933 and the beginning of 1934. It was owing to these influences that prices in Germany did not follow the downward tendency prevailing in other countries whose currencies were at par with gold, but underwent a gradual increase.

(3) An Inflationary Mentality

The main factor responsible for the continued rise in prices during 1934 was, however, the inflationary mentality of the German public. In the absence of such inflationary mentality in the United States, reflation made only slow progress, notwithstanding the efforts made by the Administration. The American public had no experience of inflation proper and did not take to hoarding goods through the mere mention of the word. If in doubt, the American producer and consumer are inclined to disbelieve in the likelihood of inflation. In Germany the mentality was totally different. The experience of 1923 was still fresh in the minds of the public. Most people still remembered the rapidly rising prices and the scarcity of commodities experienced during and after the war. The moment there appeared to be the faintest possibility of the recurrence of the experience, consumers began to cover their requirements current and future in great haste. Apart from the psychological considerations, the difference in the attitude of the American and German public towards the possibility of inflation is also explained in the immense difference in the technical position of both countries. It is evident that the United States with her huge gold reserve would be in a position to check any inflationary movement at any moment. On the other hand, in the absence of an adequate gold reserve the German monetary authorities would be in a much weaker position if confronted with an inflationary avalanche. Indeed, it was the decline of the Reichsbank's gold reserve during the first half of 1934 that gave rise to an increasing uneasiness that before long the reichsmark would have to be allowed to depreciate. At the same time, it was feared that when the Reichsbank's gold reserve

came to an end, there would be drastic restrictions of imports. Under the combined influences of these two assumptions, the public began to buy on a large scale everything that might be affected by a depreciation of the exchange, and by import restrictions. For example, everybody who could afford it, and many people who could not, ordered as many suits and dresses as possible, in anticipation of a rise in the price of textiles and of the curtailment of their supply.

The result of this urgent demand was a boom in internal trade accompanied by a sharp rise in prices. The trade balance inevitably deteriorated, partly through the heavy imports of raw material brought about by the internal boom, and partly through the effect of the rise in prices upon exports. There was in consequence a further depletion of the gold reserve. In June 1934 the gold reserve declined to such a low figure that the Reichsbank suspended the allotment of exchange for the payment of current commercial liabilities.

(4) "Gold Insolvency Standard"

The main reason why Germany was able to maintain the reichsmark at par in spite of its rising price level was that her authorities did not hesitate to limit external payments to the amount of foreign exchange they received from export. The moment a country is thus prepared to default on its liabilities, there is no reason why it should not maintain its exchange at par indefinitely, provided that exchange restrictions are effective. If the trade balance is adverse, the import surplus is simply not paid for, and old debts are also paid only if and when there is exchange available for the purpose. This system was called very appropriately the "gold insolvency standard". There is, indeed, nothing to be proud of in being able to maintain the old parity by such methods.

The circumstances of Germany's default have been subject to heated controversy. The Germans themselves maintain that they have been forced into default by the unwillingness of the creditor countries to import a sufficient amount of German goods to enable the debtor to discharge his debt. The fact is, however, that before the reflation occurred in Germany, she had a strongly favourable trade balance notwithstanding the customs barriers in other countries which already existed before 1933 and have not been materially increased since except in retaliation for German restrictions on imports. It is only since commodity prices in Germany began to rise that the trade balance has changed for the worse, for the simple reason that

German goods are no longer competitive in many of their former foreign markets. In addition, the internal boom resulted in a considerable increase of raw material imports. Any increase of internal consumption means an increase of raw material requirements. What happens if, in the absence of adequate foreign exchange resources, Germany is unable to import a sufficient quantity of raw materials? There is a tendency towards a further rise in commodity prices, since the limited supplies of commodities are confronted with an inevitably large demand. This is what happened in Germany during the second half of 1934, and if in spite of this the rise in prices was not spectacular, it was because the Government applied all its power to check it. The reflationary effect of the scarcity of commodities was not allowed fully to produce itself.

(5) Reflation was Inevitable

Germany's foreign creditors accuse her of having deliberately caused the deterioration of her trade balance by adopting a reflationary policy. Technically, their arguments are sound, but it is certain that had the German Government abstained from reflating, the spontaneous reflationary influences produced by excessive deflation would have began to operate in any case before very long. In possession of huge reserves, France and the other countries of the Gold Bloc could well afford to deflate throughout 1933 and 1934. The position of Germany was, however, totally different. Her resisting capacity was at a low ebb by 1933. She could not afford any longer the luxury of maintaining the stability of her exchange by means of continuous deflation. It is unthinkable that an impoverished country should be able to carry on indefinitely with unemployment between five million and six million, without in the long run resorting to inflation, not as a policy but as a necessity.

An alternative policy would have been reflation by means of allowing the reichsmark to depreciate. In doing so, the trade balance would have been affected favourably, so that Germany's capacity to transfer payments abroad would have been larger. On the other hand, the depreciation of the reichsmark would have inflicted heavy losses on individual debtors, since the amount of their sterling or dollar debts expressed in reichsmarks would have increased. As a result, a number of debtors would have become insolvent, which again would have facilitated the task of transferring payments by those who were in a position to bear their losses.

(6) Effect of Economic Discipline

In most other countries, the method of reflation chosen by Germany would have resulted in a disastrous decline of exports, which in turn would have reduced the means of importing raw materials to such an extent as to reverse reflation. For if owing to the lack of raw materials factories have to close down, the reduction of purchasing power thus caused leads to a decline of demand by consumers and puts an end to the internal boom. To some extent this is what actually happened in Germany. If it did not happen to a much higher degree, it was due to the system of economic discipline enforced by the National Socialist régime in the country, and to the skilful though unscrupulous manipulation of the country's foreign trade policy. Having defaulted on their commercial debts arising from goods imports during the first half of 1934, Germany promptly approached foreign countries with attempts to import on a credit basis. A variety of subtle devices have been employed with remarkable success, with the aid of which it was possible to obtain credit directly or indirectly. In the case of Great Britain, they succeeded in obtaining credit at first through the operation of an exchange agreement by which German importers of British goods were enabled to discharge their liabilities by the payment of reichsmarks into the Reichsbank. Subsequently, when this arrangement broke down, a payment agreement was concluded and the Bank of England granted a loan of £750,000 with the declared object of assisting those British exporters whose credits were defaulted upon by Germany. The real result of this transaction was, however, that those exporters, having received their money back from the Bank of England, were promptly prepared to grant new credits to Germany, so that in reality, the transaction amounted to granting a credit to Germany. In the case of France, Switzerland, Italy, etc., different methods were applied. Exchange clearing agreements were concluded, whereby German importers were enabled to discharge their liabilities through reichsmarks payments into the Reichsbank. Following upon the conclusion of these agreements, German imports from countries with which there was an exchange clearing agreement increased considerably, and very soon all those countries had a big frozen clearing balance at the Reichsbank.

At the same time, efforts were made to increase exports. Pressure was brought to bear upon firms to sell goods abroad even at a loss as a condition of obtaining payments for importing

raw material. As the firms concerned had to make good their losses by charging higher prices in the home market, this provided an additional reflationary influence.

Thanks to all these devices, those who prophesied that reflation in Germany would bring about an economic collapse and chaos have so far proved wrong, and the chances are that they will continue to be wrong. While technically Germany is doubtless the weakest country in the monetary sphere, the unscrupulousness of her financial methods in dealing with foreign interests and the economic discipline enforced in home trade goes a long way towards making up for her technical weakness. It is conceivable that Germany will continue reflating internally without having to abandon the existing parity of the reichsmark. This unnatural process cannot, however, go on indefinitely unless Germany becomes economically isolated from the rest of the world to the same extent as Soviet Russia is. In that case, the German price level will be as independent of the world level as the Russian price level is at present.

CHAPTER XLII

REFLATION IN OTHER COUNTRIES

(1) Reflation in the Sterling Bloc

Although the United States, Great Britain and Germany provided characteristic examples of three different types of reflation, the movement did not by any means confine itself to these countries. It assumed an international character, and only countries of the Gold Bloc which continued to deflate remained aloof from it. Reflation in various countries was due to a variety of causes, such as a deliberate reflationary policy; or the inability of the Governments to resist reflationary influences; or the linking of the currencies with a depreciated currency; or the effect of higher staple produce prices in the United States.

The countries of the Sterling Bloc were inevitably affected by the reflationary influences prevailing in Great Britain. Between 1931 and 1933 these reflationary influences did little more than prevent a further deflation in countries whose exchanges remained at par with sterling, such as India, Egypt or Portugal. Australia and New Zealand, on the other hand, benefited by the depreciation of their currencies to a discount of 25 per cent in relation to sterling. In the case of Australia, the depreciation took place before the general financial crisis. It was the inevitable result of adverse pressure caused partly by the extravagance of a Socialist Administration. In the case of New Zealand, however, it was a deliberate reflationary move, since there was no absolute necessity for devaluing the currency. In the case of Denmark, it is not so clear whether the depreciation of the currency was a deliberate reflationary move or whether it was the result of *force majeure*. It is true that the authorities depreciated the kroner deliberately and stabilised it approximately in relation to the pound at a lower level. Technically, they might have been in a position to defend the currency for some time at its higher level, but protection and Empire preference in Great Britain affected Denmark's trade balance to such an extent that sooner or later a depreciation of her exchange would have been in any case

inevitable. Thus, the deliberate reflationary move merely anticipated what would have happened spontaneously sooner or later.

Canada hesitated for a long time whether to follow deflation in the United States or reflation in Great Britain, and her currency fluctuated somewhere half-way between sterling and the dollar. Her dilemma was not solved until the United States suspended the gold standard and the dollar depreciated to the level of sterling. From that time onwards Canada duly shared the reflationary influences in the United States.

(2) Additions to Sterling Bloc

Several countries which subsequently joined the Sterling Bloc pursued for some time a policy of deflation until their position became untenable. In the Union of South Africa, spontaneous reflationary forces manifested themselves in the form of a wholesale flight of capital, which compelled the Government to suspend the gold standard at the end of 1932. As the South African pound adjusted itself to sterling within a few days, the equivalent of the gradual effect produced by the depreciation of sterling over a long period produced itself in the Union in the form of a rapid reflation. Nevertheless, her price level remained below that of Great Britain. In Japan, a similar situation arose over a year earlier. The yen was forced off the gold standard by a flight of capital towards the end of 1931, and its depreciation, combined with abnormal military and naval expenditure, brought about a sharp rise in commodity prices. Nor did the depreciation of the yen stop when it attained its old parity with sterling. Owing to the heavy budgetary deficit, reflationary forces were exceptionally strong and the yen went to a heavy discount compared with sterling. Since the beginning of 1933, it has been stabilised at 1*s.* 2*d.* against its parity of 2*s.* ½*d.* Estonia was the last country to join the Sterling Bloc, in July 1933. In her case the depreciation of the Central Bank's sterling balance and other reflationary influences put the country's resisting capacity to a rather severe test, and the defence of the currency at its parity for nearly two years after the suspension of the gold standard in Great Britain, the Scandinavian States, and Finland, was a remarkable achievement.

Several members of the Sterling Bloc, Sweden and Portugal in particular, pursued an individual monetary policy of their own in spite of keeping their currencies approximately stable in relation to sterling. In Sweden, it has been the declared

aim of the official policy to maintain the stability of commodity prices; while in Great Britain this result has been more or less achieved by accident, in Sweden it has been brought about by monetary management. Portugal is prepared to follow sterling so long as the latter does not fluctuate too violently. On a few occasions, the escudo was detached for a while from sterling, since it did not suit the purposes of the official policy to allow it to depreciate too much.

(3) Reflation in Central and South Eastern Europe

Reflationary influences in Central and South Eastern Europe worked in a totally different way from those in the countries of the Sterling Bloc. The Danubian and Balkan states did their utmost to resist these influences, but owing to the weakness of their technical position they were unable to resist very long. One after another, they had to allow their currencies to depreciate. At first the depreciation took place in the unofficial market. Subsequently some of them had to recognise officially the unofficial depreciation. The black bourse rates of the Austrian shilling, the Hungarian pengo, the drachma, the dinar, the leu, the leva, etc., went to a discount varying between 20 per cent and 50 per cent at a time when the official rates were still nominally at par with gold. Austria, Greece and Czechoslovakia admitted their defeat, and recognised officially the depreciation of their exchanges, but other countries are still endeavouring to uphold the fiction of the stability of their currencies at their parities. In both groups of countries, reflationary influences were set into motion to a varying degree.

In some countries spontaneous reflation assumed a peculiar form. There were a number of bank failures which the Governments were unable to prevent, and as a result the public lost confidence in all banks and reduced to a minimum its savings deposits. The difficulty was to find some other form of investing the funds. Owing to the strict exchange control, there was no way of transferring capital abroad on any large scale. Investment facilities within the countries themselves were scarce and not particularly attractive from the point of view of security. Even if the capitalists were prepared to forego yield, they failed to obtain security, for in that part of the world hoarding is not too safe. The only possible way of employing funds was to build houses, and this was done on a surprisingly large scale in Roumania and other countries. The result was a demand for building materials, a decline of unemployment, an increase in the purchasing power of consumers,

and consequently a rise in internal prices. Although the rise did not attain the same degree as in Germany, it tended to affect the trade balance adversely. But for the existence of a number of exchange clearing agreements and the default on the payment of commercial debts, it would have been impossible to resist the effect of reflation upon the exchange.

(4) Effect of Higher World Prices

Until the suspension of the gold standard in the United States, reflation in all these countries did little more than counteract deflationary influences. It is only since the depreciation of the dollar and the rise in commodity prices that accompanied it that reflation began to make itself felt in all countries with depreciated currencies.

The degree to which reflation is accompanied by trade recovery varies widely according to the local conditions and according to the extent of the depreciation of the various currencies. During the last year or two, Japan has been experiencing a period of great prosperity. Both her internal trade and her international trade have improved considerably. Owing to the low cost of production which is becoming proverbial, Japan has become a highly dangerous competitor in the world's markets. In a totally different way, Sweden is also exceptionally prosperous. The deflationary effect of the Kreuger crash was overcome much sooner than was expected, and trade improved probably to a larger extent than did that of any other European member of the Sterling Bloc. Improvements were registered also in the other Scandinavian countries, and among the Baltic countries in Finland and Estonia. Portugal is yet another bright spot, but in her case it is difficult to say how far recovery was due to the depreciation of the currency and how far it was the result of the skilful management of the country's economic affairs under the dictatorship. Among the British Dominions, Australia, New Zealand and South Africa are reasonably prosperous. The two former benefited by the rise of commodity prices after the suspension of the gold standard in the United States, though for various reasons their progress was checked in 1934. Prosperity in South Africa was assisted by the gold-mining boom. In India, reflation through the depreciation of the rupee put an end to the deflationary depression. The fact that dishoarding of gold continues in India seems to indicate that conditions are still far from satisfactory. In Palestine reflation was due to the influx of capital in connection with wholesale

immigration. The country is experiencing a remarkable boom. Among other raw-material-producing countries, Canada benefited to a large extent by the rise in wheat prices since 1933, and also by the depreciation of her exchange. Since there were no deliberate efforts in Canada to raise commodity prices, her price level is now lower than that of the United States, which circumstance stimulates Canadian trade. In Latin America, the Argentine benefited by the depreciation of the peso, which is now regarded as belonging to the Sterling Bloc. The heavy depreciation of the Chilean peso helped the country to some extent to overcome its immense difficulties.

Among the countries of Central and South-Eastern Europe, Greece benefited by reflation to the highest degree because of the extent of the depreciation of her currency. But even countries like Austria, which were thought to be ruined beyond hope, showed a remarkable degree of improvement. The fact that she abandoned her old parity without falling into the abyss of extreme inflation must have come as a severe blow to the camp of deflationary doctrinaires, whose favourite argument is that once a country which has had inflationary experience in the past departs from gold, a non-stop depreciation of its currency is inevitable. The example of Austria clearly shows that it is possible to reflate without running the risk of disaster. If there is a country where inflationary experience is still well remembered, it is Austria. Notwithstanding this, the moderate depreciation of the currency did not provoke inflationary panic, but resulted in an adequate degree of reflation to save the country from ruin. The more or less concealed depreciation of the currencies of Hungary, Jugoslavia, Bulgaria and Roumania failed to assist these countries to any material extent owing to the unwillingness of the Governments to recognise the depreciation for internal purposes. As we pointed out above, some of these countries benefited by a totally different kind of reflation brought about by the general distrust in banks and the absence of investment facilities other than real property.

CHAPTER XLIII

THE "GOLD BLOCKADE"

(1) Gold Bloc *v.* Sterling Bloc

By the end of 1934 the reflationary movement was well on its way towards assuming a world-wide character. Although adopted in different forms for different reasons and to a different degree, it was making progress over the five continents. An important group of countries continued, however, to resist reflationary influences. It included France, Italy, Switzerland, Holland, Belgium and Poland. These countries have come to be known under the name of the Gold Bloc. There are several other countries which have maintained their currencies at a fixed relation to the French franc, though they are not considered to belong to the Gold Bloc. These countries include Spain, Latvia, Lithuania, Turkey and Danzig. The maintenance of the old parities in the case of these countries is purely artificial, and is due entirely to exchange restrictions and other special measures. No attempt was made by the gold countries proper to incorporate them within the Gold Bloc for fear that they would represent a liability rather than an asset.

Before the Economic Conference, there was no co-operation, formal or informal, between the gold countries apart from the casual arrangements such as exist also between gold countries and countries with depreciated currencies. We have seen in Part III how the attitude of President Roosevelt during the Economic Conference resulted in the consolidation of the gold countries into a kind of association. Confronted with the inflationary monetary policy of President Roosevelt and with the unwillingness of the British Government to stabilise, the countries of the Gold Bloc were more determined than ever to maintain their currencies at an over-valued level. To that end, they gradually organised themselves into a financial alliance of a much more concrete nature than the vague association of countries of the Sterling Bloc. Apart from the occasional manifestoes issued by the signatories of the Ottawa Agreement, which only include Great Britain and the Dominions, there has

so far been no joint action of any kind between the members of the Sterling Bloc. While the Gold Bloc is a democratic association of theoretically equal parties, in the Sterling Bloc Great Britain pursues a policy which is to a large extent independent of the influence of any other country, and the rest of the group is at liberty to concur or leave the Bloc. The Gold Bloc is a somewhat better organised group with some collaboration based to some slight degree on reciprocity.

(2) Various Methods of Defence

The means by which countries of the Gold Bloc defended their old parities varied from country to country. There were, however, several characteristics in which the policies of practically all members of the Gold Bloc were identical. Although their budgets were unbalanced, they carefully avoided covering the deficit by inflationary borrowing. In this respect, however, their policy was identical with that of the most reflationary of all countries, the United States. Indeed, from this point of view their policy was less deflationary than that of Great Britain, whose budget had been balanced ever since the end of 1931. Another of the characteristics of the Gold Bloc's policy was to refrain as far as possible from reflationary expenditure on public works. In this respect, Italy provided a notable exception, as we shall see later. Here again, France and other members of the Gold Bloc were less orthodox than Great Britain.

None of the countries of the Gold Bloc carried on its deflationary monetary policy in the form of deliberate credit restrictions during the advanced stages of deflation. During the earlier stages of the crisis, credit was restricted by the banks for fear of losses and in order to improve their liquidity. By 1933 such restrictions had almost ceased, in fact banks were beginning to find it increasingly difficult to employ their funds, owing to the lack of demand for credits. Generally speaking, the Central Banks of the Gold Bloc maintained their rediscount rates at a low level, though in times of attacks on their currencies they resorted to the device of raising their bank rates. Thus, early in 1934, the Bank of France raised its rate to fight the adverse pressure on the franc, and towards the end of 1934 the Bank of Italy put up its rate for the same purpose. The extent to which these bank rate changes brought about a contraction of credit was not excessive, and in itself it would not have produced any marked deflationary effect.

(3) Economy Drives

It was mainly by means of economy drives that the countries of the Gold Bloc continued to deflate at this advanced stage. Their Treasuries found it impossible to keep up revenue amidst the economic depression and had to cut down expenditure to reduce the deficit. Producers and merchants, anxious to maintain their sales, had to follow the same policy. Confronted with this unpleasant necessity, the statesmen, economists and journalists of the gold countries could not be blamed for doing their utmost to make a virtue of it. They indulged in extravagant praise of the superior merits of low costs and low prices. In fact, they practised Coué-ism on a hitherto unprecedented scale. " Every day and in every way our costs are getting lower and lower, and our situation is getting sounder and sounder " was the slogan. They actually succeeded in convincing themselves that the reduction of wages, salaries, costs and prices was a good thing for its own sake, entirely independently of the causes for which it had to be done and of the object at which it aimed. They watched with satisfaction the decline of various indices, feeling very virtuous and righteous about the success of their economy drive. They imagined that as a result of this downward movement conditions were becoming sounder, and that they were making progress towards recovery.

In reality, all this was nothing but self-deception. The deflationary drives in the countries of the Gold Bloc failed to improve internal economic conditions in the countries concerned. On the contrary, they aggravated the situation. It was not only prices and wages that declined, but also employment and production. This was only natural, since the curtailment of expenditure, public and private, resulted in a reduction of purchasing power, the extent of which was probably in excess of the actual amount of the cuts. If the total of economies and reductions of expenditure by private undertakings amounts to, say, one milliard francs, the direct and indirect curtailment of purchasing power amounts to several milliards of francs, since it is not only those who are directly affected by the economies who will spend less, but also those who are affected by the reduction of the spendings of those directly affected. It is only by reducing the demand for goods that deflationary cuts can produce their full effect.

(4) Aggravating the Depression

Nor is there the least reason to suppose that the deflating countries were in any way better off after the successive economy drives than before them. By the time the cuts had produced their effect on prices, the aggravation of the depression had further reduced public revenue and purchasing power, and both the Government and private undertakings had to start afresh to cut down their spendings. This process was a vicious circle with no hope of a break.

The result of deflation upon the internal economic situation in the countries of the Gold Bloc is of great significance also from an international point of view. It is difficult to imagine a return of prosperity so long as a group of important countries continues to suffer from an acute trade depression. Although the over-valuation of the exchanges of these countries favours an increase of their purchases abroad, the decline of the purchasing power of their population more than offsets this factor, apart altogether from any artificial restrictions of imports. Although this sounds like stating the obvious, it is often overlooked. The agitation to increase the value of silver in order to increase exports to China is entirely based on the oversight of this elementary truth. It is evident that even though an appreciation of silver makes foreign goods cheaper for Chinese buyers, they are not likely to increase their purchases of foreign goods if at the same time deflationary depression reduces their purchasing power.

(5) International Repercussions

Another way in which deflation in the countries of the Gold Bloc affects the world's situation is by leading to a series of import restrictions. In order to defend their over-valued currencies the Governments of the gold countries have to do their utmost to reduce the trade deficit. As the over-valuation of their currencies makes it impossible to increase exports, the only way to reduce the deficit is by restricting imports. The increase of customs tariffs and the establishment of quotas was largely due to this effort to defend over-valued currencies. The result was retaliation on the part of the countries affected, and there was in consequence an all-round reduction in foreign trade. This is another method by which the defence of over-valued currencies by the Gold Bloc blocks the way to recovery.

Yet another important factor is the effect of deflation in the countries of the Gold Bloc upon world prices. A falling

price level in an important group of countries inevitably cancels out at least part of the effect of reflationary policy upon prices in other countries. If a certain degree of reflation in the United States would, in normal conditions, provoke a rise in the price level by, say, 30 per cent, and at the same time the price level in the countries of the Gold Bloc declines by 15 per cent, other things being equal, the rise in the United States will then be only 15 per cent. This damping effect of deflation by the Gold Bloc is bound to slow down economic recovery in the reflationary group of countries. Thus, the deflationary policy of the Gold Bloc affects not only the foreign trade of the countries outside the Gold Bloc, but also their internal trade.

(6) The Gold Bloc is Blocking the Way to Recovery

It is, therefore, obvious that the Gold Bloc is blocking the way to recovery. So long as this " gold blockade " continues, the reflationary policy in the United States and elsewhere can only produce inadequate results entirely out of proportion to the efforts. Part of the energy which should in the ordinary way bring about productive results is used up by the necessity of cancelling out the international effect of deflation in the countries of the Gold Bloc. Thus, the stubbornness with which these countries cling to their old parities penalises not only themselves, but the rest of the world. It is important to lay stress on this fact, since it provides a perfect answer to the accusations made against the British and American Governments that by their selfish monetary policy they caused grave inconvenience to the countries of the Gold Bloc. The truth of the matter is that it is the countries of the Gold Bloc which, in their short-sighted obstinacy, cause grave inconveniences to the rest of the world as well as to themselves.

In addition to pursuing a deflationary policy, the countries of the Gold Bloc have also sought to defend their currencies by efforts to establish close collaboration. The first step in this direction was taken during the Economic Conference in 1933, but it was not until late in 1934 that the Gold Bloc began to assume a more concrete form. At the Brussels Conference, held in October 1934, it was decided to negotiate trade agreements, in order to increase trade between the countries of the Gold Bloc to the extent of 10 per cent. At the same time, permanent committees were established for technical collaboration on matters of detail, such as tourist traffic. On the other hand, no agreement was reached on reciprocal support or the pooling of resources. In the monetary sphere, collaboration

was purely technical, such as exists between Central Banks in various countries. In gold countries no exaggerated hopes are attached to the practical results of the arrangements concluded. The task of increasing trade between the members of the Gold Bloc is expected to be a difficult one. In the case of trade between countries of the Sterling Bloc, an increase is in accordance with natural tendencies since these countries can produce more cheaply owing to the depreciation of their exchanges. On the other hand, the efforts to increase trade between the countries of the Gold Bloc is contrary to natural tendencies, since it means inducing each other to import from countries with higher prices instead of importing from countries with lower prices. If the endeavours to increase trade within the Gold Bloc are successful, it will mean higher prices for all the countries concerned. Thus, the result of collaboration will tend to defeat its object. While deflation tends to reduce the disequilibrium between prices within and outside the Gold Bloc, collaboration between them tends to reverse this influence.

Notwithstanding all efforts at closer collaboration, the Gold Bloc has not succeeded so far in assuming the character of an alliance proper. Recent experience unmistakably shows that members of the Gold Bloc cannot rely upon effective reciprocal support in case of emergency. When in March, M. Theunis, the Belgian Prime Minister, and one of the mainstays of the Gold Bloc, paid a visit to Paris in order to obtain trade concessions and credits to relieve the desperate plight of the belga, he had to return empty-handed. The French Government could not afford to agree to an increase of Belgian exports to France, for fear that it would aggravate the depression in France itself. Although a substantial credit was offered, it was on the condition that gold was earmarked as a security, which meant that Belgium would have used her own gold and paid interest on it. Even though it must have been evident that the refusal of an adequate support would lead to the abandonment of the Gold Bloc by Belgium, the French Government was not prepared to make any material sacrifices to prevent it. Evidently, the original slogan, " United we stand, divided we fall ", gave way to an attitude of "Everybody for himself and the survival of the fittest ". France considers it advisable to preserve her resources for her own defence, rather than reduce them in order to bolster up untenable positions in other countries. This being the case, the Gold Bloc as an alliance has lost any practical significance it may have possessed.

CHAPTER XLIV

REFLATION IN FRANCE

(1) The End of Deflation

By the end of 1934 deflation within the Gold Bloc had reached a stage beyond which it could not continue. This was recognised by the new French Government, and M. Flandin, in a statement of policy made before the Chamber of Deputies in November 1934, declared that there would be no further deflation. In Italy, too, officially inspired articles disclaimed any intention to deflate further. In both countries the official policy aimed at maintaining prices approximately at their existing levels in the hope that a rise in world prices would obviate the necessity for further deflation.

In the meantime, several countries of the Gold Bloc endeavoured to entrench themselves by organising the economic system of the country to suit the requirements of the defence of the currency. In Italy, under the pressure of the defence of the lira, Government intervention in economic activity increased. In Belgium, the Government decided to establish a strict control over production and trade. Even in France, the last stronghold of the old-fashioned economic system, the Government decided to reorganise industries in such a way as to secure for itself the possibility of intervention. It is only with the aid of a strict control of the economic factors that the Governments of the Gold Bloc can hope to hold out for a long time against the pressure caused by the over-valuation of their currencies. The situation in the countries of the Gold Bloc tends to become somewhat similar to that of Germany. By giving up deflation, these countries have to apply strict measures of control in order to maintain the stability of their currencies, notwithstanding the disequilibrium between their prices and the world price level. Not even in Italy, however, is the extent of Government control comparable to that of the control applied in Germany.

(2) NEW FRENCH MONETARY POLICY

The decision of several countries of the Gold Bloc to discontinue deflation is of great importance as a landmark in financial history. Indeed, the change of policy went a great deal further than merely abandoning deflation. In France, where the fate of the whole Gold Bloc will, after all, be determined, a new monetary policy of a distinctly reflationary character was adopted at the beginning of 1935. Although there is no indication as yet that the other gold countries will follow the French example, their currencies are linked to the franc, and just as countries of the Sterling Bloc share the fate of Great Britain, so the countries of the Gold Bloc will share the fate of France. If the reflationary monetary policy in France results in a rise in commodity prices, it will not confine itself to France, but will spread over the other countries of the Gold Bloc.

The declared object of the new French monetary policy is to improve the technical facilities of the Paris money market, and to reduce the discrepancy between interest rates on short-term credits and interest rates on long-term loans. It does not aim at reducing interest rates on short-term credits. They are already fairly low without being able to produce effects similar to those witnessed in Great Britain as a result of the cheap money policy.

The real object of the decision that the Bank of France should rediscount or grant loans on Treasury bills is to enable the Government to cover budgetary deficit by the issue of Treasury bills instead of having to depend upon the market for long-term loans. By diverting the demand for funds from the capital market to the money market, the French authorities hope to achieve a reduction in long-term money rates, since it is believed that the reason why the yield on Government securities has been round 5 per cent is the anticipation of further long-term issues.

If all that happens is that the money market absorbs an additional five milliard francs of Treasury bills, thus obviating the necessity for a long-term loan issue of a similar amount, the reflationary effect of the change will be negligible. There may be a slight decline in long-term interest rates, but its effect, if any, will be offset by a marked rise in short-term rates. It is only if the Treasury bills absorbed by the money market find their way to the Bank of France that we shall witness a more pronounced reflationary tendency. In that case, the

operation would, in reality, amount to financing a budgetary deficit by borrowing from the Bank of France. The result would be an increase in the resources of the money market, so that the decline in long-term loan rates would be accompanied by a decline in short-term money rates. This again would tend to produce a certain limited degree of economic recovery and commodity prices would rise slightly.

(3) Is French Reflation Deliberate?

On the surface, the new reflationary policy of France appears to be deliberate. In reality, the French Government merely yields to the force of circumstances. Given the fact that it will be necessary in the course of 1935 to find some ten to twelve milliard francs in order to cover the deficit, and given the fact that the capital market is not prepared to absorb anything like that amount, there was no choice but to make arrangements for inflationary borrowing. As the huge deficit was the natural consequence of excessive deflation, it is justifiable to say that all that happened in France was that deflation set in motion forces tending to reverse the downward movement.

Whether or not the new policy will produce the desired results depends on the psychological factor. It was a very skilful move to have induced the Bank of France to change its attitude towards Treasury bills at a time when there was no immediate need to do so. Had the change been made at a time when the cash reserve of the Treasury was exhausted, it would have caused panic among the French public, and the result would have been a flight from the franc. As it was, since the Treasury possessed a cash balance with the Bank of France of about one milliard francs at the time of the announcement of the new policy, the response was on the whole favourable. This does not necessarily mean, however, that the danger of panic is obviated. When the French Government begins to place the additional Treasury bills and when the market begins to rediscount them with the Bank of France on a large scale, then only will the real test come. Should the increase in loans by the Bank of France on Government securities lead to a *crise de confiance*, a flight from the franc and the accompanying crisis might prove irresistible, and the Government might be forced to suspend the gold standard or to devalue the franc. In that case, reflation would make rapid progress, not only in France, but in the remaining countries of the Gold Bloc, since they would have to follow the franc.

(4) Can France afford Reflation?

If, on the other hand, the French public takes the application of the new policy calmly, then the result will be a very slow and moderate reflation, similar to that experienced in Great Britain between 1931 and 1933. The question is whether France and the other countries of the Gold Bloc can afford a rise, however moderate, in their commodity prices. Unless it is accompanied by at least a corresponding rise in world prices, the adverse pressure on the gold currencies will increase. The example of Germany has proved, it is true, that with the aid of planning and economic discipline it is possible to withstand such an adverse pressure, but it is very doubtful whether any of the countries of the Gold Bloc, with the possible exception of Italy, would be prepared to go so far as Germany did towards Government intervention in economic life.

It is impossible to foresee how world prices will develop, but it is beyond doubt that the cessation of deflation in the countries of the Gold Bloc has removed one of the principal obstacles to effective reflation abroad. The adoption of a reflationary policy, however moderate, by France will further increase the chances of the reflationary policy of the United States becoming thoroughly effective. Its effect may, however, conceivably manifest itself in an increase of production rather than an increase of prices. Industries in the United States and other industrial countries work only to a relatively small percentage of their full capacity, and agricultural and mining production are subject to various restrictions. Any slight increase in prices would be followed by a considerable increase of production which would check a further rise. In the absence of any adequate rise in world market prices, it is doubtful whether in the long run the countries of the Gold Bloc would stand the strain caused and accentuated by their reflationary policy. Conceivably they will realise sooner or later that their efforts to maintain their currencies at an over-valued level are futile, and they will decide upon a reasonable devaluation. Conceivably their hands may be forced by the psychological effect produced by their reflationary monetary policy. The moment the public realises that the gold currencies are no longer defended with the methods of strict orthodoxy, a panic may easily arise if things go wrong in any way. The reason why the flight from the franc did not assume larger dimensions early in 1934, in spite of the adverse political and financial conditions, was that most people trusted the Government's orthodox defla-

tionary principles. With the change of monetary policy, this psychological line of defence disappeared. Should the financial or political crisis return, its effect in the form of a selling pressure on the franc would become much stronger than it was early in 1934.

The chances are that a reflationary policy in the form and to the extent to which France has decided to adopt it will not go far enough to solve the problems of the countries of the Gold Bloc. Indeed, its practical results up to the time of writing have been negligible, and in a sense even negative. The extent to which the French cheap money policy succeeded in lowering long-term interest rates was insignificant, and before long the rise of Rentes gave way to a heavy fall which brought long-term interest rates above the level where they stood prior to the inauguration of the new policy. The effect of M. Flandin's policy upon short-term interest rates has been unfavourable from the very outset. While it would be premature to pronounce a definite judgment about the result of the new policy, it is evident that the sanguine hopes attached to it have failed to materialise. France will have to resort sooner or later to a more effective form of reflation, whether as a result of a deliberate policy or under the force of circumstances.

CHAPTER XLV

THE TWILIGHT OF THE GOLD BLOC

(1) The Evil of Deflation in Belgium

While up to the time of writing reflation in France remained within the limits of a timid and unsuccessful attempt, in other countries of the Gold Bloc events began to develop with dramatic rapidity. In Belgium reflationary influences broke the Government's resistance and a devaluation of the belga by 28 per cent was decided upon at the end of March. The significance of this event cannot be sufficiently emphasised. The developments which led to it are well worth examining, since they are characteristic of the working of spontaneous reflationary forces.

Belgium was affected by the over-valuation of her currency to a particularly large extent, owing to the relative importance of foreign trade in the economic system of the country. Being highly industrialised, Belgium depends upon imports for her food and raw material supplies and it is vitally important for her to maintain her exports. For this reason, the official policy aimed at enforcing deflationary cuts ruthlessly so as to make Belgian products competitive in the world markets in spite of the over-valuation of the belga. These deflationary efforts met with increasing resistance on the part of the working classes and by the end of 1934 a stage had been reached beyond which it was impossible to continue deflation. The budgetary situation was also highly unsatisfactory, and there was no hope of eliminating the deficit either through higher taxation or through economies. In addition, as a result of the persistent depression, the banking situation also gave rise to some concern.

(2) Run on the Belga

The run on the belga that took place in November 1934 was checked after the establishment of the Government of M. Theunis. The respite proved to be, however, purely temporary. The moderate depreciation of sterling that took place during February and March 1935 further aggravated

the situation of the Belgian export trade. The prospects of a continuous decline of sterling in anticipation of the general election had an utterly discouraging effect in Belgium. It was realised that even if it were possible to make further cuts in costs, the results attained through great difficulties would be wiped out within a few days by a further fall of sterling. The number of those who realised at last the utter futility of continuing deflation was growing rapidly.

The Belgian Press did not conceal its pessimism; its attitude was not altogether unwelcome to M. Theunis since he hoped to obtain concessions from the French Government by laying stress upon the desperate plight of Belgium. We have seen in Chapter XLIII that his hopes failed to materialise. On the other hand, the pessimism of the Belgian Press gave rise to a flight of capital which proved to be the last straw and became the direct cause of the devaluation of the belga. During the second week of March, the flight of capital assumed spectacular dimensions. The National Bank of Belgium supported the exchange in Paris, but in accordance with its practice it operated only in spot belgas and left forward belgas to find their own level. Consequently, the discount on forward belgas widened to fantastic figures, which fact further accentuated pessimism.

(3) Devaluation by 28 Per Cent

After the return of M. Theunis from Paris, exchange restrictions were introduced and the Government intended to enforce drastic measures in order to save the belga. Realising, however, the extreme unpopularity of such measures and of its deflationary policy in general, the Government decided to resign. The Cabinet crisis lasted nearly a week and all the time the flight of capital continued. Since it assumed in part the form of withdrawal of deposits, it threatened to aggravate the banking situation. The defence of the belga was very costly and the reserve ratio of the National Bank declined within a fortnight from 65 per cent to 56 per cent. To avoid further losses of gold for the sake of a hopeless struggle, the Belgian authorities decided to abandon the support of the belga. While in Brussels the foreign exchange rates remained officially fixed within the gold points, in the foreign markets the belga was allowed to depreciate to something like 7 per cent discount. Even after the establishment of a Government of National Union under the Premiership of M. van Zeeland, the weak tendency continued. The atmosphere in Belgium was

becoming increasingly panicky. There was a great deal of indiscriminate buying of commodities and prices were rising rapidly.

In the circumstances the new Government had no choice but to abandon the defence of the parities. In practice, the belga had already departed from its parity before the new Government assumed office and all that was required was to recognise legally what had become a fact in practice. Although some quarters would have preferred Belgium to join the Sterling Bloc, the Government decided to resort to a straightforward devaluation to the extent of 28 per cent. At its lower level, the belga continued to be linked to gold. Simultaneously with the devaluation of the belga, the Government made a series of proposals, some of which were distinctly reflationary in character. In reality, there was no need to stimulate reflation since prices tended to rise in any case. The Belgian nation, with its experience of post-war inflation, is essentially inflation minded, and the task of the Belgian Government will not be to stimulate reflation but to regulate it.

(4) International Repercussions

The devaluation of the belga was an event of first-rate significance. Belgium was the first member of the Gold Bloc to decide to take that step. Technically she would have been in a position to continue to defend the belga and she chose to abandon the old parity before she was actually driven off it. This constitutes an important precedent which will make it easier for the other members of the Gold Bloc to devalue their currencies before they are actually swept off the gold standard.

The Belgian devaluation has shaken the confidence in the stability of the Gold Bloc to no slight extent. Prior to it, there was still a large number of people who were convinced that the Gold Bloc would be able to hold out indefinitely, or at any rate for a number of years. The Belgian example has made it evident, however, that the Gold Bloc is in reality not nearly as solid as is widely assumed. The actual material effect of the devaluation of the belga upon the rest of the gold group is also significant. It will aggravate the economic difficulties of France and the other gold countries, and will tend to strengthen the material and psychological forces working towards reflation within the Gold Bloc.

(5) Italy, Switzerland and Holland

Belgium is not the only member of the Gold Bloc in which reflationary influences have produced actual results. To a

much less extent, reflation has made some progress also in Italy. Although nominally Italy is still a member of the Gold Bloc, in reality the lira has been allowed gradually to depreciate far beyond its gold points. For some time it has been fluctuating at a discount of from 6 to 8 per cent in relation to the franc. Although the extent of reflation thus caused is negligible, it has further weakened the solidarity of the Gold Bloc currencies. It is, in fact, widely believed that Italy will gradually allow the lira to depreciate further and will thus almost imperceptibly abandon the Gold Bloc without making any spectacular gestures to that effect.

Switzerland is another weak link in the chain of the gold countries. The deflationary monetary policy of the Government is meeting with increasing opposition on the part of a large section of the population. In fact, the opponents of deflation succeeded in collecting a sufficient number of signatures for a referendum to be held in June. The programme on which the Swiss electorate will have to decide includes prohibition of further cuts in wages or further decline in produce prices, together with a number of reflationary measures such as expenditure on public works and increased unemployment benefits. If the proposals obtain a majority, the fate of the Swiss franc will be sealed. It is possible, however, that even before the referendum actually takes place the anticipation of a positive result will lead to a flight of foreign capital from Switzerland, which together with the flight of Swiss capital will increase the difficulties of resisting reflation. The banking situation is also causing much uneasiness, and may provide an additional factor hastening the decision to devalue the franc.

The Dutch guilder is hardly less vulnerable than the Swiss franc. In fact, in many quarters the view is held that Holland will precede Switzerland in devaluing her currency. The Dutch reserve ratio is lower than the Swiss and there is more likely to be a wholesale outflow of national capital from Holland than from Switzerland. Moreover, Holland is more directly affected by the devaluation of the belga than Switzerland.

(6) The End of the Gold Bloc

Before very long all gold countries are likely to follow the example of Belgium, with the possible exception of France, who with her customary stubbornness may continue to resist for a while. In fact, the French Press is already preparing

public opinion for the possibility of the financial isolation of France as the only surviving member of the Gold Bloc. It is emphasised that even if every other country abandons the Gold Bloc, France has the means of continuing to defend the franc at its existing parity.

It is difficult to imagine, however, that France will be able to continue this hopeless fight for very long. Once she becomes isolated, it will not take many months before spontaneous reflationary factors compel her to yield to the inevitable. Any further resistance will only aggravate her economic situation. Apart from any other reasons, every successful effort to restore, for the time being, confidence in the franc, will lead to the resumption of the downward movement of sterling. As it is, the depreciation of sterling is counteracted from time to time by a flight from the franc or some other gold currency. The moment this factor ceases to operate, sterling immediately becomes weaker. Thus, in trying to work out her salvation, France would merely contribute towards the accentuation of her trade depression. She has arrived at a deadlock from which she can only emerge by devaluing her currency.

CHAPTER XLVI

SUMMARY OF PART IV

(1) Results of Reflation

We have seen in the foregoing chapters the progress and results of reflation all over the world. The movement was applied in various countries to a different degree, with different methods, and in different local circumstances; it is, therefore, only natural that the results should differ widely from country to country. Japan undoubtedly heads the list of countries where reflation has produced favourable results, but Sweden and Palestine attained similar results in totally different circumstances. Reflation resulted in a moderate and varying degree of recovery in the countries of the Sterling Bloc, in the United States, in the Argentine and some other Latin-American countries, though from time to time the process was interrupted by set-backs. Even in countries such as Austria, which were affected by the crisis to a particular degree, reflation resulted in unexpected improvements. Germany experienced a noteworthy recovery, partly through reflation and partly through economic planning. On the other hand conditions in the countries of the Gold Bloc continued to change from bad to worse, owing to further deflation. In China, too, the American silver policy continued to produce deflationary results.

We have seen in the last chapter that at the time of writing, the Gold Bloc is approaching the stage when it will have to yield to the reflationary forces brought forth by excessive deflation. Reflation within the Gold Bloc is making progress, and one of the gold countries has had to yield to the pressure by devaluing its currency.

(2) Disequilibrium between Price Levels Remains

How did the process of reflation assist the world towards removing the fundamental disequilibria which was at the root of most of its troubles? Owing to the different degree to which it was applied, it has failed so far to eliminate the discrepancies between the levels of commodity prices in various countries. Since in most cases reflation took place through a depreciation

of the exchange which was not accompanied by a corresponding degree of rise in commodity prices, the discrepancies remained in force, and even increased. The deflationary efforts of the countries of the Gold Bloc were unable to reduce the discrepancies to a sufficient degree. Even within the Sterling Bloc there are wide discrepancies between price levels in various countries. Sterling is somewhat over-valued in relation to the Dominion currencies, and some other currencies of the Sterling Bloc ; it is obviously over-valued in comparison with the dollar. The countries of the gold group are also to some extent out of equilibrium with each other, owing to the difference in the degree to which they deflated. Since commodity prices in Italy failed to decline during 1934, the lira became over-valued compared with the franc. It may be said, therefore, that in 1935 the disequilibrium between the national price levels is incomparably more pronounced than it was four years earlier.

This does not, however, mean that reflation is incapable of removing or mitigating this evil. It only means that in the form it has been applied without any understanding between the nations, it was bound to accentuate disequilibria instead of liquidating it. It is only by an agreement between the nations to stabilise their exchanges at rates corresponding as closely as possible to their economic parities, that reflation could reduce the disequilibrium between national price levels. Even then, it would take some time before the reflationary forces produced their full effects, and before the process of adjustment became complete. In the absence of an agreement to stabilise exchanges in the vicinity of their economic parities, the elimination of differences between prices in various countries is bound to be a very slow process. It will take years before the tendency towards readjustment can overcome the rigidity of certain items in wholesale and retail prices, wages and the cost of living. The readjustment will be particularly difficult and slow in countries where it has to take place in a downward direction. Should all countries devalue their currencies to a considerable degree, the readjustment would necessitate a rise everywhere in prices of goods and services which is easier to accomplish and regulate than a fall. In some countries, rigidities can be overcome thanks to an increasing degree of Government intervention in economic life.

(3) Effect on Burden of Indebtedness

The question which in the long run is of even greater importance than the equilibrium between commodity prices in various

countries, is the effect of reflation upon the burden of indebtedness. How far did reflation contribute towards the restoration of equilibrium between fictitious wealth and real wealth? The answer varies according to the country. It depends upon the extent of reflation and upon the manner in which it has worked.

Reflation achieved through a policy of cheap money tends to reduce the burden of indebtedness. Although it leaves the capital amount unchanged, it leads to a reduction in interest charges. The result of a series of conversion operations carried out in Great Britain and other countries has been a distinct relief in the interest burden of the public and private debts, although the capital burden remained unaffected. This result in itself is more than sufficient justification for pursuing a persistent policy of cheap money, apart altogether from its stimulating effect upon trade activity.

If, on the other hand, reflation is achieved through an increase in expenditure, then its inevitable effect is a further increase in the burden of indebtedness. The United States and Germany provide characteristic examples of this. In both countries the relative extent of indebtedness is sufficiently low to make the burden of the additional debt bearable. A stage may eventually be reached, however, when reflation in these countries defeats its object by raising the burden of public debt to an intolerably high level. Much depends of course upon the result of reflation. If it succeeds in raising commodity prices or creating additional real wealth to a sufficient extent to balance the increase of fictitious wealth, its beneficial effects will not be offset by the cost at which they were attained.

(4) Reflation through Devaluation

The most effective way in which reflation has reduced the burden of indebtedness has been through the depreciation of the currencies. The rise in commodity prices that followed the depreciation and subsequent devaluation of the dollar contributed towards the reduction of the burden of fictitious wealth, not only in the United States but also in other countries. It is indeed the only really effective way in which the capital burden of excessive indebtedness can be reduced at all. Reflation through cheap money policy only affects the interest burden and leaves the capital burden intact. Reflation through public expenditure may cause an increase in the burden of indebtedness unless the addition to the public debt is cancelled out by depreciation of the currency. Reflation through an increase in

the price level unaccompanied by the devaluation of the currency may reduce temporarily the burden of fictitious wealth, but in the long run the rise in commodity prices is likely to be followed by a fall which cancels out the beneficial results. Devaluation on the other hand tends to reduce the burden of indebtedness by causing commodity prices to rise without adding anything to the public debt. Indeed, the amount of public debt is actually reduced by the surplus created through the revaluation on the gold reserve.

Unfortunately, the actual extent to which reflation has so far reduced fictitious wealth is negligible. Even in the United States commodity prices are only slightly above pre-war level, while in the countries of the Sterling Bloc they are just around their pre-war figure. The inadequate result of reflation is due to the deflationary policy of the Gold Bloc since the fall in commodity prices in the gold countries prevented commodity prices in countries with depreciated currencies from rising to an extent comparable with that of the depreciation of their exchanges. While commodity prices are not expected to rise to the full extent corresponding to the depreciation of the currencies, they certainly ought to rise in future a good deal more than they have risen so far as a result of the cessation of deflation by the Gold Bloc.

(5) A Haphazard Movement

It is evident that reflation is taking place in a haphazard way just as inflation, stabilisation and deflation took place. There is no trace of any international co-ordination of the movement. Indeed, within the particular countries themselves there is no trace of any real understanding of the problems involved or of any deliberate policy conscious of its aims. With the exception of the United States, no country has adopted reflation with the declared object of reducing the burden of indebtedness. The sole reason for which a deliberate policy of reflation has been adopted in the United States is that the class of debtors which has been affected to a particular extent by deflation happens to be politically very important. In countries like Great Britain, where an unduly large part of the excessive fictitious wealth assumes the form of a gigantic public debt, there is no evidence of any political pressure favouring the reduction of this burden through reflation. And yet excessive public debt in Great Britain affects the nation in the same way as excessive private indebtedness in the United States affects the American nation. The only difference is that while in the United

States the increased burden of fictitious wealth manifests itself in a direct increase in the burden of mortgages, in Great Britain it leads to an increase of taxation, whose connection with excessive fictitious wealth is not evident to the man in the street. The number of those who have realised that reflation must make much more substantial progress in order to reduce the burden of excessive fictitious wealth is very small. Notwithstanding this, the trend of development is moving in the right direction, even in the absence of a deliberate policy conscious of its object.

(6) Prospects of Reflation

It appears probable that the process of reflation will continue to make headway during the next few years. As far as the United States is concerned, the gigantic programme of public works which has just been adopted is bound to accentuate reflation, even though its effect upon the fictitious wealth of the country will be largely cancelled out by the increased burden of the public debt. If reflation through budgetary deficits should lead to a material rise in commodity prices in the United States, and if the rise spreads over other countries, the rest of the world will then benefit by the process at the expense of the United States. The latter can only reduce materially the burden of her excessive indebtedness by making prices rise faster than the increase of her public debt, and this end can only be achieved through a further devaluation of the dollar.

The prospects of reflation in Great Britain are also decidedly favourable. The price level will follow, to a large extent, that of the United States. Reflation in Great Britain may possibly become accentuated through a further depreciation of sterling. It is widely believed that such a depreciation will take place, if not earlier, at any rate during the period preceding the general election. It is also possible that in anticipation of the election the Chancellor of the Exchequer will loosen the purse strings, and Great Britain will go in, to some extent, for reflationary public expenditure. Should the general election return a Labour Government, reflation would become accentuated both through a slump in sterling and through public expenditure on a really large scale.

Reflation in the countries of the Sterling Bloc would, to a large extent, keep pace with British reflation, though some countries at any rate are quite prepared to pursue an individual monetary policy. For instance, Japan is likely to continue to reflate on a large scale as a result of armament requirements.

(7) Attitude of the Gold Bloc

A most important unknown factor in the equation is the future of the Gold Bloc. As we pointed out in the previous chapter, the chances are that, sooner or later, France and the other countries of the Gold Bloc will devalue their currencies. Such an action will, of course, increase considerably the progress of reflation, not only in the countries concerned but all over the world. In this respect the devaluation of the belga was a most important step in the right direction.

If all countries of the Gold Bloc were to devalue, and if countries with depreciated currencies were to devalue further, it would provide ample scope for future currency expansion. It would lead in the long run, either to a considerable rise in commodity prices or to a marked increase in the production of real goods, or, what is most probable, there would be a marked rise in both prices and production. As a result, both the absolute burden and the relative burden of fictitious wealth would be likely to decline considerably. If, on the other hand, the depreciated currencies were stabilised at or above their present levels, and if the countries of the Gold Bloc did not devalue, then the scope for a further material reduction in the burden of fictitious wealth would remain rather limited. Notwithstanding the efforts of the United States and one or two other countries, reflation would then not go far enough to bring about an adequate degree of readjustment in the ratio between fictitious wealth and real wealth. In that case, the only possibility of the elimination of the disequilibrium without another disastrous upheaval, would be a material increase in production. In the absence of an adequate degree of economic planning, however, there is little hope of attaining that end.

CHAPTER XLVII

CONCLUSION

(1) Limitations of Monetary Policy

The facts of the financial history of the last twenty-one years can be interpreted in many different ways, and a great variety of conclusions can be inferred from them. Some people use these facts as a warning against inflation, others as a warning against deflation, while others again as a warning against stabilisation. All these conclusions are correct in a sense, but they contain only part of the truth. The fact of the matter is that neither inflation, stabilisation, deflation nor reflation can be judged solely on the basis of the experience of recent years. While each one of these movements has disadvantages inherent in it, many of the disadvantages experienced since 1914 were due to the defective planning or execution of the various monetary policies. Above all, general conditions were such as to make it impossible to carry out a monetary policy satisfactorily. The much quoted remark of Baron Louis, Finance Minister under the Restoration, to his colleagues in the Cabinet, "*Faites moi une bonne politique and je vous ferai de bonnes finances,*" holds good more than ever. Even the most skilfully planned and executed monetary policy would have been unable to produce satisfactory results amidst the conditions prevailing since 1914.

Those whose task is to criticise the statesmen responsible for the world's monetary management during this unsettled period have to bear in mind the factors which were outside the scope of monetary policy. Anyone inclined to attack the Governments of Europe for having pursued a wanton inflationary policy during the war should be reminded gently but firmly that the declaration of war was not an act of monetary policy, and that given the fact of the world war of unprecedented dimensions, there was no choice but to inflate in order to finance the national defence. Quite recently the suggestion was put forward that in future the profits will be taken out of the war, presumably by a system of 100 per cent war profit duty. Although such a solution might be conceivable under a system of planned economy, it was absolutely inconceivable under the

system of liberal capitalism that existed in 1914. But even if all army contractors had supplied goods entirely without profit, there would have been none the less a spectacular increase in public expenditure which, coupled with the shortage of commodities, would have rendered an inflationary trend inevitable.

(2) The Fundamental Mistake

Where the statesmen who ruled the world during and immediately after the war went wrong was not that they inflated, but that they expected inflation to produce no lasting effect. They considered it reasonable to multiply the public debt, and yet to act as though nothing had changed. Given the fact that by 1918 the public debt in every belligerent country, and to a large extent also in neutral countries, had increased far beyond its figure of 1914, the policy aiming at restoring the pre-war value of currencies was absurd. The fundamental mistake in the sphere of monetary policy was committed, not in 1914 when the Governments embarked upon an inflationary policy, but in 1920 when they adopted a policy which ignored completely the consequences of their inflationary policy. It was then that the " original sin " which became the root of most of our troubles ever since was committed.

In 1920 the natural trend of commodity prices to adjust themselves to the new equilibrium between fictitious wealth and real wealth was artificially checked by the monetary authorities of the leading countries. It was an error of immense magnitude and the world is still paying for it. Admittedly, it would have been perhaps too much to expect the statesmen of 1920 to realise what may appear obvious to us fifteen years later. Having learnt in Nineteenth-Century text-books or from pre-war experience that whenever there is a boom the thing to do is to check it by increasing the bank rate and restricting credit, the bankers and politicians acted according to their lights. They failed to realise that there is a difference between a cyclic boom and the fundamental trend of commodity prices to adjust themselves to the new situation created as a result of years of inflation. The same primitive mentality which was responsible for raising the bank rate in London to 10 per cent in August 1914 was also responsible for interrupting the natural and desirable process of adjustment.

(3) Unreasonable Deflation

Possibly one of the reasons why the fundamental error of interrupting the process of adjustment in 1920 was committed

was that the extent to which such adjustment was necessary varied according to countries. It was comparatively small in the United States, especially as it was then assumed that a large part of the public debt increase during the war would be cancelled out as a result of war-debt payments by the allies. In any case, the burden of public debt and other forms of fictitious wealth in the United States in 1920 was far from being unbearable, if we take into consideration the immense wealth of that country. For this reason, the extent to which the increase of fictitious wealth in the United States necessitated a permanent depreciation of the dollar was relatively small.

In Great Britain the state of affairs was totally different. Over seven milliards of pounds of internal public debt constituted a staggering burden compared with the material resources of the country. Nor did Great Britain possess vast natural resources comparable with those of the United States which would have justified hopes that within a reasonable time the increase of real wealth would reduce the relative burden of the increased public debt. There was little reason to expect that within a few years it would be possible to spread the burden over a considerably larger amount of national income. Notwithstanding this, the British post-war statesmen considered it a matter of honour that sterling should be stabilised at its old parity in relation to the dollar. It was not until 1931 that Great Britain realised how ill she could afford to pursue such a policy of prestige.

Those who could afford to follow the American-British example, and those who thought they could afford to do so, embarked upon a policy of deflation from 1920 onwards. Those who obviously could not afford to deflate plunged themselves into the other extreme by inflating recklessly. Had the currencies been stabilised at the level to which they depreciated in 1920, a number of countries of the inflationary group might have avoided further inflation.

(4) Reckless Inflation

While the countries of the deflationary group pursued a deliberate deflationary policy, inflation in many of the countries of the inflationary group was the inevitable result of circumstances which escaped the influence of monetary policy. Excessive reparations demands against Germany, political upheavals and the weakening of the Government's authority in Germany, Austria and Hungary, civil war in Russia, the necessity of repairing war damages in France and other countries,

etc., were factors which would have produced inflation no matter what monetary policy the Governments concerned had tried to carry out. Conceivably in some cases the degree of inflation might have been lower if the Governments, Parliaments and the public had taken up a more energetic stand in resisting inflation. But in the case of the worst offenders, at any rate, the *forces majeures* tending to produce inflation were so powerful that any effort to resist them would only have prolonged the agony, without making much difference in the approximate extent to which the currencies depreciated.

Internal political upheavals, like wars, constitute a *force majeure* under whose pressure inflation is inevitable. It cannot be emphasised sufficiently that it was these factors and not an inflationary monetary policy that brought about extreme inflation in the countries concerned. It is well to realise that if the adverse political circumstances in which inflation occurred in Central and Eastern Europe after the war repeated themselves, even the most stubborn determination of the Governments to avoid the recurrence of the disaster would not prevent extreme inflation. It is equally important to bear in mind that nothing short of the repetition of those political circumstances could ever produce again extreme inflation.

(5) Monetary Expansion and Planning

Above all, it is of the utmost importance to realise that the monetary expansion which took place during and after the war was not planned and regulated, but allowed to occur in a haphazard way. No effort was made to make adequate use of the creative power of monetary expansion for the benefit of the nations. For this reason alone it is not justifiable to quote the examples of post-war inflation in order to discourage monetary expansion however moderate and however productive. Those who maintain that the experience of the period between 1914 and 1926 has taught us a lesson to oppose to the utmost even the slightest departure from rigid orthodoxy have completely misread the lessons of the financial history of the war and of the post-war period. The financial experience of the years of extreme inflation may be a warning against war, against revolution, against reparations demands beyond the defeated country's capacity to pay, but it certainly does not constitute a warning against monetary expansion as such. It constitutes a warning against uncontrolled inflation whether moderate or extreme. It constitutes a warning against inflation undertaken for essentially unproductive purposes. Over and above every-

thing, it constitutes a warning against inflation of every kind undertaken under a system of liberal capitalism.

Those who maintain that a policy of monetary expansion, if undertaken for productive purposes and within reasonable limits, is an essentially constructive and beneficial policy are right, but only if they add that such expansion can only be undertaken with impunity under a system of planned economy. Under a system based mainly on *laissez faire*, monetary expansion can only lead to a speculative boom, overproduction and various disequilibria, which sooner or later are bound to bring about a slump. Inflation was bound to show itself at its worst, not merely because of the political circumstances in which it was undertaken, not merely because it was undertaken for unproductive purposes in an unscientific manner, but also because it was undertaken under a system of liberal capitalism. It is only if a central authority keeps a tight grip on production and distribution that monetary expansion can lead to a permanent increase of human welfare. Under a system of liberal capitalism, monetary expansion is highly risky and the slump that follows the boom wipes out most of what has been achieved during the boom. Those who advocate planned monetary expansion in an unplanned economic system are guilty of grave inconsistency.

(6) Why Stabilisation Failed

If inflation was a failure, so was stabilisation. The reasons were almost identical. Between 1925 and 1931 political and politico-financial factors were in an utterly unsettled state. In the circumstances, to pretend to ourselves that everything was normal or that it would gradually become normal was gross self-deception. Also, stabilisation, like inflation, was carried out in an unscientific way, without regard to the underlying factors whose equilibrium is a preliminary condition of lasting stability. The level chosen for stabilisation did not allow for the expansion of fictitious wealth in relation to real wealth ; it did not allow for the discrepancies between price levels in various countries ; it did not allow for the inadequacy of the world's gold supply, nor for the technical weakness of some currencies, owing to the maldistribution of gold. In the absence of economic planning, there was no possibility of a gradual readjustment and there was no hope for the elimination of disequilibria. Under a system of planned economy, it might have been possible gradually to increase the volume of real wealth sufficiently to provide a *raison d'être* for the increased volume of fictitious wealth.

Under *laissez faire* such readjustment was impossible, for the increase of production was bound to lead to a speculative boom, and this was bound to be followed by a collapse. Under a system of planned economy, it would have been possible to eliminate the discrepancies between the price levels in various countries. Under the system of *laissez faire*, however, various factors affecting prices were too rigid to be readjusted automatically, and they were entirely outside the control of the authorities.

Given these facts, it is not surprising that stabilisation should show itself at its very worst. But to infer from the experience of 1925–31 that something must be inherently wrong with stabilisation is just as erroneous as the conclusion that monetary expansion is necessarily evil. There are circumstances in which monetary stabilisation works out to the benefit of mankind. These circumstances are a reasonable degree of political stability, a choice of the right level of stabilisation, and the maintenance of stability with the aid of economic planning.

(7) Stability Leads to Boom

In the absence of economic planning, not only inflation but also prolonged stability is likely to lead to a speculative boom. If, during a series of years, business activity is not discouraged by deflation, human nature being what it is, the world is likely to be seized by a wave of optimism, leading to reckless gambling. Indeed, the only way to avoid such booms under a system of liberal capitalism is to prevent the development of a period of prosperity by a moderate but constant deflation. This is, indeed, the ideal which orthodox economists would like to have achieved. They do not feel happy and safe unless trade remains at the very lowest point it touched during the crisis. According to them, whenever there is a slight recovery from the deepest degree of depression, it should be strangled instantaneously by a new dose of deflation. That is the only method under *laissez faire* which, in their view, can prevent crises. In other words, if we renounce prosperity and progress, if we abandon the hope that inventions will ever lead to an improvement in the standard of living, then we may be compensated by a feeling of stability. If we are satisfied with the bare level of subsistence, we do not run the risk of a relapse. Under a system of *laissez faire* we have to choose between the economics of poverty and the constant insecurity of wide and ever-increasing fluctuations through which mankind may progress in spasms. Throughout the Nineteenth Century this spasmodic progress produced good

results in the long run. Conditions have changed, however, since the war. Owing to the increase of fictitious wealth and to the development of fundamental disequilibria and the complex nature of the international financial system since the war, the dimension of booms and slumps is likely to be a multiple of what it was before the war. In the changed conditions under a system of liberal capitalism stability is only conceivable in the form of perpetual depression. It is only under a system of planned economy that stability is not incompatible with lasting progress uninterrupted by relapses.

(8) Planning Mitigates Evils of Deflation

Deflation is the necessary evil which accompanies liberal capitalism. Under that system, credit restriction is the only effective weapon in the hands of Governments for checking speculative boom, over-production, or over-trading. Indeed, the only way in which such progress as can be achieved under the system is expected to manifest itself is through a fall of prices as a result of an increase of production and of a decline in the cost of production. The alternative method of passing the benefit of progress on to the consumer in the form of higher wages has proved to be inpracticable under the system of *laissez faire*. An attempt at such a solution is the principal object of the New Deal that is being adopted in the United States.

In our opinion, deflation is inherently evil with practically no redeeming features. Under a system of planned economy, its evil qualities may be mitigated, thanks to the greater facility for making the necessary adjustments in various types of incomes and prices. But planned economy could go further by reducing the necessity for deflation. Even under planned economy, however, deflation might from time to time become necessary in order to correct the effect of miscalculations. If it is found that for some reason the purchasing power distributed among consumers becomes excessive compared with the volume of goods available, then it might become necessary to readjust the position with the aid of all-round cuts in purchasing power, though the solution of raising prices in order to restore the equilibrium is probably preferable.

(9) Deflation not Unavoidable

Between 1929 and 1934 deflation occurred in the same haphazard way as inflation and stabilisation occurred during the previous periods. As in the case of inflation and stabilisation, economic planning might go a long way towards mitigating the

evil effects of deflation, but it is difficult to imagine conditions in which deflation becomes actually advantageous. One of the most important results of recent financial experience is that mankind has become fully aware of the destructive effects of deflation. Nor can *force majeure* be claimed to be the cause of the destructive result as in the case of extreme inflation. If a country is at war or in the middle of a revolution, or if it is confronted with fantastic claims for reparations, it has no choice but to inflate to the extreme. It is, however, impossible to imagine conditions in which countries are compelled to resort to such extreme deflation as we have witnessed during the past five years. If the circumstances in which this deflation occurred return, the remedy lies entirely in our hands as the example of the countries which depreciated their currencies rather than continue to deflate has conclusively proved. It is only the orthodox idea that " whatever happens we must retain our currencies linked to gold at the existing parities " that makes countries become ready victims of deflationary forces.

(10) Need for Planned Reflation

Reflation has proved a satisfactory remedy against deflation, even though it has failed so far to recover much of the ground lost prior to its advent. The movement has not yet reached a sufficiently advanced stage to enable us to form a definite opinion about its merits and demerits. Evidently, it is suffering from the same handicap as the three previous fundamental movements, namely, from troubled general conditions, from the haphazard way of its execution and from the absence of economic planning. With the aid of planning, if possible on an international scale, it would be possible to obtain the full advantage of reflation. As it is, we have to be satisfied with such advantages as arise notwithstanding the conditions which are adverse to the experiment.

One thing is certain, unless reflation is planned and executed more scientifically, in itself it is not likely to cure the evil of excessive fictitious wealth, and unless it is accompanied by planning in the economic system as a whole, it is likely to lead to the recurrence of the situation in which the world found itself in 1929. Possibly, the lessons taught by the experience of recent years were not sufficient to make mankind realise the supreme importance of planning. It is conceivable that the improvement brought about by reflation, and the progress towards rational planning in many countries, will be followed by a relapse into all the vices that accompany economic free-

dom. In that case, the world will inevitably receive another lesson to make it realise which way the trend of evolution is moving, and the advent of such a lesson will be a mere question of time.

(II) The Right Monetary Policy

Evidently, under the system of *laissez faire* no monetary policy can produce satisfactory results in the changed conditions created by the war. What is then the system which, given the fact of the continued existence of a high degree of *laissez faire,* is likely to produce the least unsatisfactory results? According to the orthodox school of thought, our salvation lies in the return to the gold standard, possibly with certain minor modifications. In their opinion, our monetary policy should be based upon the principle of maintaining the stability of the monetary unit in relation to gold, and while trying our best to prevent unduly wide movements in commodity prices, if the choice lies between internal stability and international stability of the currency, we should sacrifice the former for the sake of the latter without hesitation. According to the various radical schools of thought, the gold standard should be either discarded definitely or the parities should be adjusted on the basis of the index of commodity prices. In their opinion, monetary policy should aim at maintaining the stability of the internal price level even if it is at the cost of having to put up with fluctuations in the international value of the currency. Both solutions have grave inconveniences.

There is, however, an intermediate solution which combines the advantages of both extremes, and while it is impossible to claim that this solution would eliminate their inconveniences, it certainly would reduce them to a minimum. This solution is to adopt the gold standard on the understanding that the alteration of parities can be decided upon as a matter of expediency whenever the necessity for it arises. The monetary authorities would endeavour to maintain commodity prices as stable as possible under the existence of a stable international value of the currencies, but would not hesitate to sacrifice the stability of the international value of the currencies if confronted by heavy and persistent adverse pressure. The difference between this system and that of the currency whose gold value is regulated by the index of commodity prices is that according to our proposal minor movements in commodity prices should be ignored; it is only major movements that

should lead to alterations of the parities. What matters is that the situation in which the monetary authorities consider it their duty to make the utmost sacrifices to maintain the existing parities in spite of major pressure against them should never recur again.

To give the proposed system a fair chance it would be essential that its inauguration should be preceded by a drastic devaluation of the major currencies and their stabilisation as closely as possible to their new economic parities. In doing so the abnormal discrepancies between the price levels of the leading countries would be eliminated and the disequilibrium between fictitious wealth and real wealth would be reduced. Without such preliminary measures the new system would be put to an unduly severe test. In any case it would be merely a temporary solution. The permanent solution lies in economic planning.

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